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## COMPETITIVE DEBACLE IN LOCAL TELEPHONY: IS THE 1996 TELECOMMUNICATIONS ACT TO BLAME?

REZA DIBADJ\*

### INTRODUCTION

With much ado, President Bill Clinton signed the Telecommunications Act of 1996<sup>1</sup> into law on February 8, 1996. Setting lofty expectations for the new law, the President declared boldly that “[t]oday, with the stroke of a pen, our laws will catch up with our future. We will help to create an open marketplace where competition and innovation can move as quick as light.”<sup>2</sup>

Indeed, the 111-page statute boasted the ambitious goal “[t]o promote competition and reduce regulation in order to secure lower prices and higher

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1. Telecommunications Act of 1996, Pub. L. No. 104-104, 502, 110 Stat. 56 (codified in various sections of 47 U.S.C. §§ 151-612).

2. News Release, Remarks by the President in Signing Ceremony for the Telecommunications Act, Conference Report (Feb. 8, 1996), *available at* <http://clinton4.nara.gov/WH/EOP/OP/telecom/release.html>. This optimism seems to have been shared at the state level as well. *See, e.g.*, Alan Johnson, *What's the Hangup?*, COLUMBUS DISPATCH, Oct. 21, 2001, at 1E (“This job’s done. The road to competition is open.”) (quoting David Johnson, a former member of the Public Utilities Commission of Ohio, on June 12, 1996, when the new Ohio phone regulations were approved). For a discussion of federalism issues, see *infra* Part IV. Note that such optimism was felt internationally as well. *See, e.g.*, Organisation for Economic Cooperation and Development (OECD), Working Party on Telecommunications and Information Services Policies, Local Telecommunication Competition: Developments and Policy Issues, Doc. No. OCDE/GD(96)179 (1996) 6, *available at* <http://www.oecd.org/dataoecd/00/00/M000014000/M00014297.pdf> [hereinafter 1996 OECD Report] (“Over the next two years the balance between competitive and monopoly markets will fundamentally change with the majority of countries with monopolies moving to liberalise their PSTN markets.”).

quality services for American telecommunications consumers and encourage the rapid deployment of new telecommunications technologies.”<sup>3</sup> The Act touches many areas of telecommunications,<sup>4</sup> but its core is focused on breaking the monopoly of the incumbent local exchange carriers (ILECs)—more specifically, the regional Bell operating companies (RBOCs)<sup>5</sup>—and promoting competition in local<sup>6</sup> telephony.<sup>7</sup>

As the old saying goes, “that was then, this is now.” Seven years after the passage of the Act, it is regretfully safe to posit that the telecommunications field is in total disarray. It is one thing to observe that the press has stated as much.<sup>8</sup> It is quite another to note that even the Federal Communications

3. § 502, 110 Stat. at 56 (purpose statement). *See also* S. CONF. REP. NO. 104-230, at 1 (1996) (describing the Act as creating a procompetitive national policy framework that sought to eliminate barriers to competition in local telecommunications).

4. For an overview of the key issues raised by the Act, see Alden F. Abbott, *The Telecommunications Act of 1996: Success or Failure?* (Apr. 1999) (unpublished manuscript), available at [http://techcenter.gmu.edu/programs/papers/Abbott\\_Telecom\\_Act.1996.pdf](http://techcenter.gmu.edu/programs/papers/Abbott_Telecom_Act.1996.pdf); Deonne L. Bruning, *The Telecommunications Act of 1996: The Challenge of Competition*, 30 CREIGHTON L. REV. 1255 (1997).

5. The current RBOCs are SBC, Qwest, Verizon, and BellSouth. These RBOCs comprise 93% of ILEC access lines and billed access minutes. *See* Federal Communications Commission, *Statistics of Common Carriers*, Table 2.6 (2001/2002 Edition) (Sept. 15, 2002), available at [http://www.fcc.gov/Bureaus/Common-Carrier/Reports/FCC-State\\_Link/SOCC/01SOCC.pdf](http://www.fcc.gov/Bureaus/Common-Carrier/Reports/FCC-State_Link/SOCC/01SOCC.pdf) [hereinafter FCC SOCC Report]. In addition, as of December 31, 2000, the RBOCs controlled 87% of ILEC loops, as follows: Verizon (32.6%), SBC (31.9%), BellSouth (13.3%), Qwest (9.31%). The remaining 13% consists of non-RBOC ILECs such as cooperatives that serve rural areas. *See* Federal Communications Commission, *Industry Analysis and Technology Division, Wireline Competition Bureau, Trends in Telephone Service*, Table 8.3 (May 2002), available at [http://ftp.fcc.gov/Bureaus/Common\\_Carrier/Reports/FCC-State\\_Link/IAD/trend502.pdf](http://ftp.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/trend502.pdf) [hereinafter FCC Telephone Trends].

6. For the purposes of this Article, “local” is defined as within a local access and transport area (LATA). A LATA, in turn, is “roughly as big as the area covered by one area code.” JEAN-JACQUES LAFFONT & JEAN TIROLE, *COMPETITION IN TELECOMMUNICATIONS* 284 (2000). A more technical definition of LATA is a “geographically defined exchange area, created by the AT&T divestiture decree, beyond which a local Bell operating company would not carry telephone calls; generally centered in a metropolitan area.” INGO VOGELSANG & BRIDGER M. MITCHELL, *TELECOMMUNICATIONS COMPETITION* 324 (1997). *See also* 47 U.S.C. § 153(25) (2002).

7. *See, e.g.*, Jim Chen, *The Magnificent Seven: American Telephony’s Deregulatory Shootout*, 50 HASTINGS L.J. 1503, 1576 (1999) (“Congress plainly intended the opening of the local exchange to be the centerpiece of the Telecommunications Act.”); Henry Geller, *The 1996 Telecom Act: Cutting the Competitive Gordian Knot*, 29 CONN. L. REV. 205, 205 (1996) (“The impetus for the Act, however, was the need to deal with the telephone area, especially local telecommunications.”); Tim Sloan, *Creating Better Incentives Through Regulation: Section 271 of the Communications Act of 1934 and the Promotion of Local Exchange Competition*, 50 FED. COMM. L.J. 309, 311 (1998) (“The overriding goal of the 1996 Act is to promote competition in all telecommunications markets. But Congress was particularly concerned about introducing and expanding competitive entry into local telecommunications service markets.”).

8. *See, e.g.*, Roger Parloff, *What a Difference 18 Months Make*, IEEE SPECTRUM, Sept. 1, 2002, at 24 (“[T]he industry has been in meltdown . . . capped off, on 21 July [2002], by WorldCom’s filing for bankruptcy protection against its creditors.”); Brett Pulley, *Commander of the Airwaves*, FORBES, Apr. 29, 2002, at 78 (“Now the communications industry is under siege. Telecom companies are buried in debt and are reporting multibillion-dollar losses. The fiber glut has sent tens of thousands of

Commission (FCC) agrees. At a recent conference, FCC Chairman Michael Powell did not mince his words when he soberly declared:

[t]his is an industry suffering—there have been nearly 500,000 jobs lost, a reported \$2 trillion of market value extinguished, and by some estimates companies are laboring under nearly \$1 trillion in debt . . . . These difficult times in the telecommunications industry have understandably raised anxiety high, sometimes even bordering on hysteria . . . . Few are prospering. Few are growing. Few are spending. Few are investing. The status quo is certain death and can no longer be considered a viable option.<sup>9</sup>

Ironically, local telephony, the area that the Act was supposed to help the most, is faring the worst. The once much-vaunted competitive local exchange carriers (CLECs) that were supposed to bring competition to the local market have been a failure. As the Association for Local Telecommunications Services points out, “[m]ore than 50 CLECs have filed for bankruptcy over [2000-2002] and several others have disappeared without notice.”<sup>10</sup> The market capitalization of publicly traded CLECs dropped 95%—from \$86

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workers to the unemployment offices.”).

9. Michael K. Powell, Chairman, Federal Communications Commission, Remarks at the Goldman Sachs Communicopia XI Conference (Oct. 2, 2002), *available at* [http://www.fcc.gov/Daily\\_Releases/Daily\\_Business/2002/ab1002/DOC-226929A1.pdf](http://www.fcc.gov/Daily_Releases/Daily_Business/2002/ab1002/DOC-226929A1.pdf) [hereinafter Powell Communicopia Remarks]. *See also* Yochi J. Dreazen, *FCC'S Powell Says Telecom "Crisis" May Allow a Bell to Buy WorldCom*, WALL ST. J., Jul. 15, 2002, at A1 (Powell noting that the industry is in “utter crisis”); Reinhardt Krause, *Telecom Shakeout Is Nearing an End: Bankruptcy Wave Ebbs But There's Still No Sense of What the Telecom Field Will Look Like When It's Over*, INVESTOR'S BUS. DAILY, Jan. 2, 2002, at A10 (“Telecom firms defaulted on a record \$33.1 billion in bonds in 2001.”); Written Statement of Michael K. Powell, Chairman, Federal Communications Commission, Financial Turmoil in the Telecommunications Marketplace: Maintaining the Operations of Essential Communications, Address Before the Committee on Commerce, Science and Transportation of the United States Senate (July 30, 2002), *available at* [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC-224797A1.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-224797A1.pdf) [hereinafter Powell Senate Statement], (“Clearly, the telecommunications industry is riding on very stormy seas.”). For an overview of the bleak outlook in the debt markets, see Robert Konepal, Statement Before the Federal Communications Commission En Banc Hearing on Steps Toward Recovery in the Telecommunications Industry (Oct. 7, 2002), *available at* [http://www.fcc.gov/enbanc/100702/konefal\\_statement.pdf](http://www.fcc.gov/enbanc/100702/konefal_statement.pdf).

10. Association for Local Telecommunications Services, Annual Report: The State of Local Competition 2002, at 5 (Apr. 2002), *available at* <http://www.alts.org/Filings/2002AnnualReport.ppt> [hereinafter ALTS Annual Report]. *See also* Robert W. Crandall & J. Gregory Sidak, *Is Structural Separation of Incumbent Local Exchange Carriers Necessary for Competition?*, 19 YALE J. ON REG. 335, 341 (2002) (“Indeed, the competitive sector of the telecommunications industry is in serious jeopardy as several CLECs have declared bankruptcy, missed revenue targets, curtailed entry into new markets and laid off employees. Moreover, these impacts are not limited to CLECs (and their customers); these effects are also being felt upstream with the manufacturers of telecommunications equipment themselves.”). Two of the most notable bankruptcies are NorthPoint Communications and Winstar Communications.

billion to \$4 billion—between 1999 and 2001.<sup>11</sup> Only one publicly traded CLEC, GCI in Alaska, was profitable in 2002.<sup>12</sup> One article in the business press has even stated that “Darwin’s theory of natural selection is running amok [in the telecommunications industry].”<sup>13</sup>

How could things go so terribly wrong? Obviously, regulation in general, let alone the Telecommunications Act of 1996, cannot explain everything. Overall macroeconomic and geopolitical events will necessarily have an important impact,<sup>14</sup> as will poor business judgment of new market entrants who fashion unrealistic business plans.<sup>15</sup> However, the importance of regulation should not be underestimated; after all, it created the environment in which (otherwise rational) business people dreamed up business plans that are ridiculed today. Moreover, to the extent that the telecommunications bust was a major contributor to the recession, its regulation did in fact drive many of the other negative macroeconomic events. As Chairman Powell has pointed out, “there have been real policy failings that have played a role in the industry’s demise.”<sup>16</sup>

Where have those policy failings been? Are they within the Act itself? Criticizing the Telecommunications Act of 1996 seems to have become a pastime of sorts. One newspaper article sums up the sentiment of many:

The Telecommunications Act of 1996 promised nothing short of a telephone revolution. Local phone service from a vast array of phone companies; calls delivered over everything from cable TV lines to electric wires; and prices driven down by relentless competition.

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11. See ALTS Annual Report, *supra* note 10, at 13.

12. See *id.* at 5.

13. Reinhardt Krause, *Local Phone Firms Struggle to Survive in Funding Drought*, INVESTOR’S BUS. DAILY, Oct. 4, 2001, at A6. See also Barbara Etzel, *A Reckoning for CLECs: Huge Debtloads, Recession and Post-Sept. 11 Jitters Put Upstarts’ Survival in Question*, INV. DEALERS DIGEST, Nov. 19, 2001. For a thought-provoking, cynical opinion piece on what really went on behind the scenes according to the President of the Progress and Freedom Foundation, see Jeffrey Eisenach, *The Real Telecom Scandal*, WALL ST. J., Sept. 30, 2002, at A16 (“The [CLECs] lost \$82 billion in market capitalization between 1999 and 2001. But the investment bankers, and many CLEC insiders, made out handsomely. A conservative guess is that the banks took away more than \$1 billion in commissions and fees, and one study of just seven CLECs showed insiders selling off stock worth more than \$1.3 billion in 2000 and early 2001.”).

14. For an overview of macroeconomic trends affecting telecommunications, see Simon Wilkie, Statement Before the Federal Communications Commission FCC En Banc Hearing on Steps Toward Recovery in the Telecommunications Industry (Oct. 7, 2002), available at [http://www.fcc.gov/enbanc/100702/Wallace\\_statement.pdf](http://www.fcc.gov/enbanc/100702/Wallace_statement.pdf).

15. See, e.g., Crandall & Sidak, *supra* note 10, at 390-97.

16. Powell Communicopia Remarks, *supra* note 9.

Instead the law, signed by former President Bill Clinton five years ago today, delivered gridlock.<sup>17</sup>

Even the Supreme Court has chastised the statute, writing that:

It would be gross understatement to say that the 1996 Act is not a model of clarity. It is in many important respects a model of ambiguity or indeed even self-contradiction. That is most unfortunate for a piece of legislation that profoundly affects a crucial segment of the economy worth tens of billions of dollars.<sup>18</sup>

Leading academic commentary seems to agree with the Supreme Court. Many point to the fact that the Act “maintains a basic confusion of goals and policies that has permeated telecommunications policy for thirty years,”<sup>19</sup> that it “substantially fails to deliver on its large promises,”<sup>20</sup> or that it “has generated more controversy than progress.”<sup>21</sup> One has even written that the Act’s rhetoric reads like “Eisenhower-era predictions that atomic power would soon cost too little to meter and that we would commute via jetpacks.”<sup>22</sup> At best, certain commentators are lukewarm.<sup>23</sup>

As usual, many are also quick to blame the court system. Some point to the practical effect of the Act becoming “a vehicle for clever interpretation, exploitation and litigation,”<sup>24</sup> or a “boon only for lawyers and regulators, while consumers have felt few benefits.”<sup>25</sup> Former FCC Chairman Reed

17. Martha McKay, *Local Competition Still Elusive; After the Revolution Firms Bickering Dashes Telecom Act Hopes*, THE RECORD (Bergen County, NJ), Feb. 8, 2001, at B1. In an opinion piece in the same newspaper a year later, former FCC Commissioner Susan Ness wrote: “Six years later, too many consumers are still waiting.” Susan Ness, *Should Verizon Enter New Jersey’s Long Distance Market?; No: Entry Will Deter Local Competition*, THE RECORD (Bergen County, NJ), Jan. 8, 2002, at I13.

18. AT&T Corp. v. Iowa Utils. Bd., 525 U.S. 366, 397 (1999).

19. Paul L. Joskow & Roger G. Noll, *The Bell Doctrine: Applications in Telecommunications, Electricity, and Other Network Industries*, 51 STAN. L. REV. 1249, 1279 (1999).

20. Lance Liebman, Foreword: *The New Estates*, 97 COLUM. L. REV. 819, 825 (1997).

21. Michael J. Doane et al., Response, *Having Your Cake—How to Preserve Universal-Service Cross Subsidies While Facilitating Competitive Entry*, 16 YALE J. ON REG. 311, 311 (1999).

22. REGULATORS’ REVENGE: THE FUTURE OF TELECOMMUNICATIONS DEREGULATION 1 (Tom W. Bell & Solveig Singleton eds., 1998).

23. See, e.g., Thomas W. Hazlett, Commentary, *Explaining the Telecommunications Act of 1996: Comment on Thomas G. Krattenmaker*, 29 CONN. L. REV. 217, 217 (1996) (“[The] Act, like any such legislation, is simply the opening round of a regulatory process.”); Thomas G. Krattenmaker, *The Telecommunications Act of 1996*, 29 CONN. L. REV. 123, 123 (1996) (pointing out that the law is “good” where it removes barriers and bad or even “ugly” where it does not; and noting amusingly that a statute that defines “telecommunications in a manner such that it includes the act of mailing a letter or throwing a newspaper on the lawn, cannot be all that special”).

24. Rob Frieden, *Regulatory Opportunism in Telecommunications: The Unlevel Competitive Playing Field*, 10 COMM.LAW CONCEPTUS 81, 84 (2001).

25. Eric M. Swedenburg, Note, *Promoting Competition in the Telecommunications Markets*:

Hundt, a principal architect of the Act, has even stated that if he could rewrite the law, he “would have eliminated everything the courts thought was a loophole [as] Courts have picked on tiny word choices by Congress and used them as excuses for intervening in telecom policy.”<sup>26</sup>

This Article challenges the conventional notion that the Act itself is to blame for the lack of competition in local telephony, and that somehow courts are complicit in this failure. Rather, it argues that regulators took the solid underpinnings of the statute and translated them into poor regulations even at the most basic level. Ironically, it is the courts that have done their best to inject some notion of sanity to regulations that often appear out of control. Put simply, the Act has gotten a bad rap. By and large, Congress and the courts are not to blame; shockingly poor implementing regulation is.

Part I of this Article outlines a few fundamentals upon which the subsequent analysis is based. It argues that despite technological advances, access to the local wireline telephone infrastructure is still critically important. Further, there is precious little competition today in wireline telephony, and competition can flourish only with appropriate regulation. Part II examines the Act’s network disaggregation provisions, with a particular focus on two fundamental questions: What portions of the network should be unbundled? And at what price? It argues that while the statute itself is sound, the regulations promulgated under it evince basic economic confusion that has harmed the ILECs, and provoked a series of reactions and retaliations. Surprisingly and ironically, the unbundling provisions have decimated the CLECs—the very people the regulations were supposed to help. A new regulatory framework is proposed.

Part III shifts to consideration of the Act’s provisions that open up long distance to RBOCs and argues that while the overly formalistic statutory language may have some flaws, again, the implementing regulations have floundered—this time to the advantage of the RBOCs.<sup>27</sup> Again, a possible solution is explored. Part IV considers the thorny subject of federalism—here, unlike unbundling and long distance, the complexities appear to be an inevitable part of our broader federal system. Nonetheless, Congress was again able to devise an innovative new approach—this time to address evolving issues of federalism.

A fundamental theme throughout Parts II, III, and IV is that, contrary to

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*Why the FCC Should Adopt a Less Stringent Approach to Its Review of Section 271 Applications*, 84 CORNELL L. REV. 1418, 1419-20 (1999).

26. See Reinhardt Krause, *Telecom Act? More Like Lawyers’ Full-Employment Law*, INVESTOR’S BUS. DAILY, Feb. 5, 2001, at A8.

27. For a discussion of a potential exception around RBOC long distance entry, see *infra* Part III.

Chairman Hundt's belief, the courts have tried their best to backfill for the FCC, and that their intuition about where to intervene has been excellent. The courts are, however, limited as a generalist judiciary by lack of institutional expertise.

In the end, the Article argues that getting the fundamentals of deregulation right will go a long way to curing the telecommunications industry's ills. Chairman Powell has stated that the need for regulatory reform is most pressing in local markets where a network access policy "that promotes competition, investment and innovation to deploy advanced networks"<sup>28</sup> is needed. Put simply, this Article argues that rather than tossing out the Act, a better approach would be for the FCC to develop regulations that coincide with economic and technological reality.

One methodological point is worth emphasizing before beginning. It is important to recognize (often with some amusement), the glaring inconsistencies inherent in the position of many telecommunications companies. The RBOCs, for their part, engage in vociferous rhetoric on the benefits of competition in long distance<sup>29</sup> while at the same time quietly violating the law and paying fines to preserve their local monopolies.<sup>30</sup> New entrants to the local market, especially long distance companies,<sup>31</sup> sing the praises of local competition in telephony while at the same time fighting to preserve their own monopolies beyond telephony, notably AT&T in cable.<sup>32</sup> This Article does not dwell here, since it is not concerned with competitor welfare. Rather, it takes a dispassionate view, based on law and economics, to frame the issue in terms of maximizing consumer welfare. Society's interests should drive the debate.

## I. FUNDAMENTALS OF LOCAL TELEPHONY

### A. Local Wireline Infrastructure Is Still Important

A fundamental threshold question arises as to whether the local wireline plant is still relevant and worthy of debate in telecommunications law and policy. The short answer is yes; despite advances in wireless technologies, local telephone loops will remain an essential element of infrastructure for the foreseeable future.

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28. Powell Senate Statement, *supra* note 9, at 14-15.

29. *See infra* Part III.

30. *See infra* Part II.D.

31. New entrants are also known as interexchange carriers (IXCs).

32. *See* Reza Dibadj, *Toward Meaningful Cable Competition: Getting Beyond the Monopoly Morass*, 6 N.Y.U. J. LEGIS. & PUB. POL'Y 2 (forthcoming) (manuscript on file with author).



There are several reasons underlying this claim. First is the ubiquity of the telephone network. As of November 2001, 95% of households in the United States had telephones.<sup>33</sup> Wireline local service comprises \$132 billion, or 44%, of the telecommunications industry's entire revenues.<sup>34</sup> RBOCs' total plant-in-service is estimated to be well above \$300 billion.<sup>35</sup>

It is true that with regard to voice communications, wireless technologies have had an impact on the importance of the local wireline plant. There are already 128 million wireless access lines<sup>36</sup> versus 180 million wireline access lines,<sup>37</sup> with wireless growing rapidly<sup>38</sup> and wireline declining slightly.<sup>39</sup> However, it is very unlikely that, even for voice communications, cellular phones will replace land lines. A variety of factors, including reliability, quality, and coverage, suggest this result.<sup>40</sup> If Internet telephony ever

33. One hundred million, two hundred thousand out of 107.7 million households. See FCC SOCC Report, *supra* note 5, Table 5.2. For a detailed examination of telephone penetration by state over time, see Federal Communications Commission, Industry Analysis and Technology Division, Wireline Competition Bureau, Telephone Penetration by Income by State (Apr. 2002), available at [http://ftp.fcc.gov/Bureaus/Common\\_Carrier/Reports/FCC-State\\_Link/IAD/pntris01.pdf](http://ftp.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/pntris01.pdf). For a detailed examination of telephone penetration by demographic variables, see Federal Communications Commission Industry Analysis and Technology Division, Wireline Competition Bureau, Telephone Subscribership in the United States (Feb. 2003), available at [http://ftp.fcc.gov/Bureaus/Common\\_Carrier/Reports/FCC-State\\_Link/IAD/subs0702.pdf](http://ftp.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/subs0702.pdf).

34. Local service is the largest portion. Long distance (toll) comprises \$94 billion (31%), wireless comprises \$76 billion (25%), and payphone companies \$1 billion (<1%). See FCC SOCC Report, *supra* note 5, Table 5.13.

35. It is estimated to be \$333 billion as of end of year 2000. See Robert E. Hall & William H. Lehr, *Rescuing Competition to Stimulate Telecom Growth* 5 (Sept. 2001) (unpublished manuscript), available at <http://www.sandhillecon.com/hlpaper/hlpaper.pdf>.

36. See *In re* Implementation of Section 6002(b) of the Omnibus Budget Reconciliation Act of 1993, Annual Report and Analysis of Competitive Market Conditions with Respect to Commercial Mobile Services, App. C, Table 1 (FCC No. 02-179, July 3, 2002) (Seventh Report), available at [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/FCC-02-179A2.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-02-179A2.pdf) [hereinafter FCC Wireless Report]. Note that the numbers reported are slightly different than those reported in Federal Communications Commission, Industry Analysis and Technology Division, Wireline Competition Bureau, Local Telephone Competition: Status as of June 30, 2002, Table 11 (Dec. 2002), available at [http://www.fcc.gov/Bureau/Comm\\_Carrier/Reports/FCC-State\\_Link/IAD/lcom1202.pdf](http://www.fcc.gov/Bureau/Comm_Carrier/Reports/FCC-State_Link/IAD/lcom1202.pdf) [hereinafter FCC Local Competition Report]. The reason for this small discrepancy is that the FCC Local Competition Report only lists subscribers from wireless systems who have more than 10,000 subscribers. See FCC Wireless Report at 19 n.112.

37. See FCC Telephone Trends, *supra* note 5, Table 8.1.

38. At the passage of the Act, there were 38 million wireless access lines. See FCC Wireless Report, *supra* note 36, App. C, Table 1.

39. There were 188.6 million wireline access lines in 2000. See FCC Telephone Trends, *supra* note 5, Table 8.1. Note that some of this decline may be due to consumers substituting a single high-speed digital subscriber line (DSL) line for two phone lines (one for data, one for voice). See also *infra* note 48.

40. For example, wireless systems are still prone to low-quality voice transmissions and "dead zones" where the connection is dropped. They are also less reliable for critical applications such as emergency 911. See Sharon Pian Chan, *Wireless Phones Come Home: Ads Push for Everywhere Use*, SEATTLE TIMES, Mar. 18, 2002, at C1.

becomes significant, it will be delivered into homes and businesses via land lines.<sup>41</sup> Cable telephony has gotten off to a slow start and will likely remain marginal for the foreseeable future.<sup>42</sup>

Beyond voice, perhaps an even greater reason why telephone land lines will remain ubiquitous is that they can transmit data much more efficiently than wireless infrastructure, which has been a significant disappointment so far.<sup>43</sup> Moreover, given significant development and rollout costs, there are strong doubts around the future of third-generation cellular (3G), which promises much higher data transmission rates.<sup>44</sup> Other technologies, such as fixed wireless<sup>45</sup> and satellite, are currently impractical; in the words of a recent Organisation for Economic Cooperation and Development (OECD) report, alternative technologies have developed “much slower than expected.”<sup>46</sup>

Cable, on the other hand, does present a compelling technology option for data transmission, at least for households.<sup>47</sup> In broadband, cable modems

41. As recently as 2001, analysts were singing the revolutionary praises of Internet telephony. For example, an OECD Report praised Dialpad.com, which could offer “free web to phone domestic voice telephony service to US customers.” Organisation for Economic Cooperation and Development, Working Party on Telecommunication and Information Services Policies, Interconnection and Local Competition, Doc. No. DSTI/ICCP/TISP(2000)3/FINAL (2001) 6, available at <http://www.oecd.org/pdf/M00003000/M00003019.pdf> [hereinafter 2001 OECD Report]. But companies such as Dialpad.com are now espousing much more traditional business models—for example, focusing on the long distance market and charging by the minute. *New U.S. Monthly Plans*, at <http://www.dialpad.com> (last visited Feb. 28, 2003). Moreover, Internet telephony has so far proven to be a disappointment, given issues with voice quality and latency.

42. See Federal Communications Commission, *In re Ninth Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, ¶¶ 49-52 (FCC No. 02-338, Dec. 31, 2002) (MB No. 02-145) (Ninth Annual Report), available at [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/FCC-02-338A1.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-02-338A1.pdf). The latest FCC report indicates that cable-delivered IP telephony, which uses data packets over the Internet, is not yet commercially practical, so cable operators are using circuit-switched telephony, which routes data packets through traditional telephone circuits. See *id.* ¶ 49 n.150. Moreover, there are only 2.1 million cable telephony subscribers. See *id.* ¶ 50. Note that this lackluster performance may be due to cable operators’ desire to protect core video revenues above everything else. See Dabadj, *supra* note 32.

43. For example, systems such as “wireless access protocol” (WAP) have proven to be a failure. See Junko Yoshida, *3G: In Like a Lion, Out Like a Lamb?*, ELECTRONIC ENGINEERING TIMES, Oct. 7, 2002, at 1.

44. See *id.*

45. For example, Local Multipoint Distribution Service (LMDS) and Multichannel Multipoint Distribution Service (MMDS) only serve niche markets. For an overview of the technology, see Federal Communications Commission, *In re Inquiry Concerning the Deployment of Advanced Telecommunications Capability to All Americans in a Reasonable and Timely Fashion, and Possible Steps to Accelerate Such Deployment Pursuant to Section 706 of the Telecommunications Act of 1996*, App. B, ¶¶ 31-44 (FCC No. 02-33, Feb. 2, 2002) (CS Docket 98-146) (Third Report), available at [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/FCC-02-33A1.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/FCC-02-33A1.pdf) [hereinafter FCC Inquiry].

46. 2001 OECD Report, *supra* note 41, at 9.

47. See Dabadj, *supra* note 32.

compete with Asymmetric Digital Subscriber Lines (ADSL)<sup>48</sup> to allow high-speed data<sup>49</sup> communications to homes. The latest FCC statistics indicate five million ADSL lines and nine million cable lines—nearly a two-to-one advantage for cable.<sup>50</sup> But even here local telephone lines offer the only real competition to cable. Moreover, the cable industry is not a symbol of good health and innovation: new entrants such as RCN Corporation are in dire straits, and incumbents are piling on staggering amounts of debt in an effort to finance closed, proprietary networks that protect core video revenues.<sup>51</sup>

Beyond the residential market, the importance of wireline access increases even more. If other wireline and fiber<sup>52</sup> are added to the DSL lines above, then noncable wireline infrastructure comprises 42% of high-speed lines, cable comprises 57%, and satellite/fixed wireless comprises 1%.<sup>53</sup> The vast majority of businesses that do not have access to cable infrastructure must rely on other wireline infrastructure for their data needs.

In sum, wireline infrastructure still plays a critical role in moving both voice and data, and is very unlikely to be supplanted by cable or wireless technologies anytime soon. There is significant local wireline infrastructure investment that is not going anywhere.<sup>54</sup> Local landlines could paraphrase Mark Twain's famous quip, "reports of my death are greatly exaggerated."<sup>55</sup>

### *B. Local Telephony Markets Are Still Not Competitive*

The next threshold question to consider is whether there is competition in the local telephony market. The four large RBOCs—SBC, Verizon, Qwest,

48. DSL is a technology that allows traditional low-bandwidth copper loops designed for voice communications to carry data at high speeds. ADSL, which is a subset of DSL technology used in the residential market, provides speeds in one direction greater than speeds in the other direction (*i.e.*, usually subscriber download speeds are significantly higher than upload speeds). For an overview of DSL technologies, see FCC Inquiry, *supra* note 45, App. B, ¶¶ 24-30.

49. High-speed lines are lines that allow at least 200 Kbps (thousand bits per second) connection in at least one direction. See Federal Communications Commission, Industry Analysis and Technology Division, Wireline Competition Bureau, High-Speed Services for Internet Access: Status as of June 30, 2002, Table 1 n.1 (Dec. 2002), available at [http://fcp.fcc.gov/Bureaus/Common\\_Carrier/Reports/FCC-State\\_Link/IAD/hspd1202.pdf](http://fcp.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/hspd1202.pdf) [hereinafter FCC Access Data].

50. See *id.* Table 1.

51. See Dibadj, *supra* note 32.

52. Wireline technologies other than ADSL include traditional telephone high-speed services (for example, expensive T-1 lines) and symmetric DSL. Fiber includes optical fiber to the subscriber's premises. See FCC Access Data, *supra* note 49, Table 1 n.2.

53. In other words, out of the 16.20 million high-speed lines, 5.10 million are ADSL, 9.17 million are cable, 0.52 million are fiber, 1.19 million are other wireline, 0.22 million are satellite/fixed wireless. See *id.* Table 1.

54. For a detailed discussion of sunk costs in the context of access pricing, see *infra* note 163.

55. JOHN BARTLETT, FAMILIAR QUOTATIONS 625 (15th ed. 1980).

and BellSouth<sup>56</sup>—still dominate local markets.<sup>57</sup>

There are several indications that seven years after the Act's passage, the amount of competition is still woefully inadequate. From a revenue perspective, only 10%, or \$13 million out of the \$132 million wireline local service provider revenue is from ILEC competitors.<sup>58</sup>

Furthermore, FCC statistics indicate that about 11% of switched access lines are CLEC lines.<sup>59</sup> If cable lines are excluded, then the number is closer to 10%.<sup>60</sup> If the analysis is confined to residences and small businesses, less than 8% of access lines are competitive.<sup>61</sup> Moreover, there are significant differences on a state-by-state basis, with a maximum of 25% competitive access lines in New York being an anomaly.<sup>62</sup>

The picture is similar for high-speed lines, where CLECs control approximately 8% of DSL lines<sup>63</sup> and about 17% of all noncable high-speed lines.<sup>64</sup> Surprisingly, the FCC indicates that ILECs have been adding residential high-speed data customers at a faster rate than CLECs.<sup>65</sup>

Robert Crandall and Gregory Sidak note that the “vision held by some of radically different market structure for local telecommunications has thus far failed to materialize.”<sup>66</sup> A *Business Week* article mentions that the “local telecom markets remain almost complete monopolies.”<sup>67</sup> Note, for instance,

56. BellSouth operates primarily in the southeastern United States, Verizon in the northeast, SBC in the midwest and southwest, and Qwest in the west and northwest. See Federal Communications Commission, Selected FCC Form 477 RBOC Local Telephone Data as of June 30, 2002, available at [http://www.fcc.gov/Bureaus/Common\\_Carrier/Reports/FCC-State\\_Link/IAD/RBOC\\_Local\\_Telephone\\_June\\_2002.xls](http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/RBOC_Local_Telephone_June_2002.xls).

57. When the Act was passed, there were seven RBOCs, plus GTE. Verizon purchased Nynex and GTE, Qwest purchased USWest, and SBC purchased Ameritech. For a discussion of the effects of these mergers, see Chen, *The Magnificent Seven*, *supra* note 7.

58. See FCC SOCC Report, *supra* note 5, Table 5.13. See also FCC Telephone Trends, *supra* note 5, Table 9.7. Note that the RBOCs comprise over 90% of ILEC access lines. See *supra* note 5.

59. This amount is derived from 21.6 million CLEC lines divided by 189.1 million total lines. See FCC Local Competition Report, *supra* note 36, Table 1. See also ALTS Annual Report, *supra* note 10, at 8 (CLECs reported to have 9.9% share, or 19.5 million out of 198 million lines).

60. Cable comprises 2.6 million of CLEC lines and none of ILEC lines. See FCC Local Competition Report, *supra* note 36, Table 5.

61. See *id.* Table 2. Part ILC, *infra*, posits that inefficient access pricing has created this disparity.

62. See FCC Local Competition Report, *supra* note 36, Table 6.

63. See FCC Access Data, *supra* note 49, Table 5. These non-ILECs have 226,000 of the 5.1 million ADSL lines and 269,000 of the 1.2 million other wireline lines.

64. See *id.* Thus, in addition to their presence in the ADSL and other wireline categories, non-ILECs have 682,000 of the 742,000 other lines (*e.g.*, optical fiber). This also indicates that CLECs tend to compete more for the advanced-services market.

65. See FCC Inquiry, *supra* note 45, ¶ 51.

66. Crandall & Sidak, *supra* note 10, at 337.

67. Steve Rosenbush & Peter Elstrom, *8 Lessons from the Telecom Mess*, BUS. WK., Aug. 13, 2001, at 60. See also Jeffrey Kosseff, *A Tough Act to Follow Qwest*, THE SUNDAY OREGONIAN, Jan.

the contrast between two OECD reports written five years apart. In 1996, OECD wrote that “the main reason governments are increasing liberalisation of local telecommunications markets is because there is growing recognition that the same dynamism evident in other segments of the industry is necessary if information infrastructure goals are to be realised.”<sup>68</sup> By 2001, its perspective had become more cynical, commenting that the “local telephone market has thus remained a *de facto* monopoly in spite of the liberalisation of the telecommunications market.”<sup>69</sup>

As the Department of Justice has pointed out in the context of antitrust policy, competition “tends to drive markets to a more efficient use of scarce resources.”<sup>70</sup> Competition generally enhances consumer welfare—recall that the local telephony monopoly has never been a paragon of innovation.<sup>71</sup> For instance, as Figure 1 shows, prices have decreased significantly in the long distance market, where competition is robust.<sup>72</sup> By contrast, monthly charges for local telephony have increased.

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27, 2002, at G01 (lamenting “slick sales pitches rather than improved service . . . confusing bills rather than lower prices, and . . . consolidation rather than competition”).

68. 1996 OECD Report, *supra* note 2, at 20.

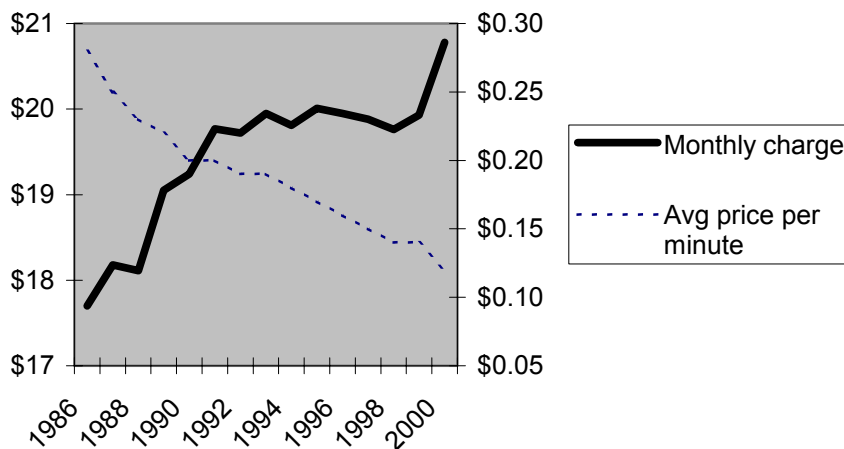
69. 2001 OECD Report, *supra* note 41, at 9. This pattern seems familiar in other OECD countries as well. The recent OECD report noted that CLEC market shares in member countries were barely 4% and stated that “competition in the local market has not developed to a significant degree and a significant number of consumers in OECD countries do not have any choice but to use the incumbent’s local voice telephony services.” *Id.* at 8. The thirty OECD member countries are comprised mostly of the developed economies of North America and Western Europe. See OECD member Countries, at <http://www.oecd.org/EN/countrylist/O,,EN-countrylist-o-nodirectorate-no-no-159,0,00.html>.

70. William J. Kolasky & Andrew R. Dick, The Merger Guidelines and the Integration of Efficiencies into Antitrust Review of Horizontal Mergers 2 (Department of Justice, 2002), available at <http://www.usdoj.gov/atr/hmerger/11254.htm>. For a more detailed look at the benefits of competition, see Dibadj, *supra* note 32.

71. See, e.g., Dhruv Khanna & Bruce M. Aitken, Symposium: Innovation and The Information Environment, *The Public’s Need for More Affordable Bandwidth: The Case for Immediate Regulatory Action*, 75 OR. L. REV. 347, 352 (1996) (“Unlike competitive businesses, the monopoly LECs are not adept at innovation, deploying new services, expanding output or otherwise successfully seizing new business opportunities.”).

72. In 2001, long distance carrier toll-service revenue shares were: AT&T, 37.5%; WorldCom, 23.5%; Sprint, 9.3%; other long distance carriers, 29.7%. See FCC SOCC Report, *supra* note 5, Table 1.5. Cf. FCC Telephone Trends, *supra* note 5, Table 10.1.

Figure 1: Average Long Distance Toll Prices Per Minute vs. Local Residential Service Monthly Charge<sup>73</sup>



As the *New York Times* has pointed out, “[t]he slow pace of competition for consumers may be one reason local phone rates have continued to keep pace with inflation since 1996 while long-distance rates have tumbled sharply.”<sup>74</sup> Granted, there are structural differences, especially given that cross-subsidies distort true cost in local telephone service.<sup>75</sup> But the point still stands: without competition in long distance, prices would not have declined; without competition in local telephony, prices are likely to remain high and innovation low.

### C. A Critical Role for Regulation

Having established that local wireline telephony infrastructure is both important and noncompetitive, the final threshold question is whether regulation can do anything to help the situation. Several years ago there were cries to dismantle the federal regulatory system and rely on some combination of tort law, state agencies, and the private sector.<sup>76</sup> Leaving

73. FCC Telephone Trends, *supra* note 5, Tables 14.1 & 14.4.

74. Seth Schiesel, *For Most Local Phone Users, Choice Is Not Yet an Option*, N.Y. TIMES, Nov. 21, 2000, at C1.

75. See *infra* notes 168-72.

76. See, e.g., PETER W. HUBER, LAW AND DISORDER IN CYBERSPACE: ABOLISH THE FCC AND LET COMMON LAW RULE THE TELECOSM (1997); Bell & Singleton, *supra* note 22, at 2 (“[S]erious regulatory reform must include long-term plans for closing down the FCC.”); David J. Buerger,

aside the sheer impracticality of having different state agencies or a common law tort system administer national telecommunications policy, the realization has emerged that, especially in industries with large incumbent monopolies, the idea of free atomistic competition is a fallacy. Recent writings in the business press suggest that not enough regulation, or poor deregulation, has led to the current economic crisis.<sup>77</sup> In a cynical post-Enron world, some even go so far as to propose that proper regulation can help save capitalism itself.<sup>78</sup>

Noted economists have also argued the importance of regulation to telecommunications competition. Professors Jean-Jacques Laffont and Jean Tirole use the example of New Zealand, where regulatory oversight was abolished, then reinstated,<sup>79</sup> to demonstrate the “difficulty of ensuring competition in the absence of regulation.”<sup>80</sup>

Professor Howard Shelanski finds that innovations have been more rapidly developed in competitive telecommunications markets, and he writes that “regulators and enforcement officials should be wary of claims that, by adhering to policies designed to preserve competition, they will impede firms from deploying innovations or bringing new services to consumers.”<sup>81</sup> Perhaps most tellingly, Professor Lawrence White, generally not a supporter of regulation, told the *Washington Post*: “I even half choke on the words as I say them, but there’s got to be regulatory intervention. *Otherwise, the whole issue of local competition is truly a joke.*”<sup>82</sup>

The regulatory gestalt is also changing to recognize this reality. Former FCC Chairman William Kennard has noted that “[i]ntroducing competition

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*Enough Is Enough. Why It's Time to Get Rid of the FCC*, NETWORK WORLD, June 5, 1995, at 65.

77. Beyond telecommunications, examples include the demise of the Glass-Steagall Act in banking leading to conflicts of interest and the lack of derivatives regulation creating suspicious off-balance sheet financing instruments. *See, e.g.*, Jacob M. Schlesinger, *What's Wrong? The Deregulators: Did Washington Help Set Stage for Current Business Turmoil?*, WALL ST. J., Oct. 17, 2002, at A1. Amusingly, Bernie Ebbers, former CEO of WorldCom is quoted as saying that the FCC rules implementing the Act were “absolutely fabulous.” *See id.* at A12.

78. *See, e.g.*, Kurt Eichenwald, *The Nation: Clay Feet; Could Capitalists Actually Bring Down Capitalism?*, N.Y. TIMES, June 30, 2002, at D1.

79. In late 2001, the government of New Zealand created the role of Telecommunications Commissioner. *See* New Zealand Ministry of Economic Development, *Landmark Telecommunications Act Passed* (Dec. 18, 2001), available at <http://www.med.govt.nz/pbt/telecom/minister20011218a.html>. This action was partly in response to evidence that the incumbent, Telecom, was abusing its market power to the detriment of new entrants such as Clear. *See, e.g.*, Liam Dann & Rosemary Howard, *Change a Way of Life for “Other Woman”*, SUNDAY STAR-TIMES (Auckland), Mar. 3, 2002, at 4.

80. LAFFONT & TIROLE, *supra* note 6, at 34.

81. Howard A. Shelanski, *Competition and Deployment of New Technology in U.S. Telecommunications*, 2000 U. CHI. LEGAL F. 85, 85 (2000).

82. *See* Peter S. Goodman, *FCC Sitting Out Telecom War; Bells Stand to Benefit from New Chairman's Neutrality, Economists Say*, WASH. POST, May 3, 2001, at E1 (emphasis added).

in monopoly markets requires consistent pro-competition intervention by the government . . . . *This thought that if the government gets out of the way, competition will somehow spontaneously bloom, I just don't get it.*"<sup>83</sup> Perhaps surprisingly, current FCC Chairman Michael Powell, an avowed believer in laissez-faire economics,<sup>84</sup> recently shared the following telling comment: "One of the things I find as a regulator, the pattern is always the same. An innovator loves a free market—until they get big. Then they want to pull up the ladder. One of our more sacred responsibilities is to never take the heat off big companies."<sup>85</sup>

Consistent with this "newfound aggressiveness,"<sup>86</sup> the FCC has even asked Congress for more power—for example, to enforce local competition provisions<sup>87</sup> or to protect consumers of now-bankrupt firms.<sup>88</sup> For the first time since 1970, the FCC has even denied a merger, refusing to transfer licenses in the attempted EchoStar/DirecTV merger.<sup>89</sup>

While the FCC correctly recognizes the power of regulation, its challenge is to use it properly and consistently and not repeat past mistakes.<sup>90</sup> For example, this Article argues that the FCC's unbundling regulations ignore basic economic principles<sup>91</sup> and that it has recently been too lax in approving RBOC entry into long distance.<sup>92</sup> These actions have dealt a devastating blow to proper implementation of the Act.

83. Seth Schiesel, *Sitting Pretty: How Baby Bells May Conquer Their World*, N.Y. TIMES, Apr. 22, 2001, at C1 (emphasis added).

84. Chairman Powell has begun to point out, however, that the press had overplayed his belief in the power of hands-off government. See Parloff, *supra* note 8, at 24.

85. See Powell Says Telecommunication Litigation Is to Be Expected, LOC. COMPETITION REP., July 1, 2002 [hereinafter *Litigation Expected*]. This is consistent with a later speech Chairman Powell gave in New York where he asked: "[D]o regulators have at their disposal tools of sufficient power to drive forward economic growth and productivity by altering the telecommunications regulatory landscape? The market will always be the principal driver, but I think the answer is yes." Powell Communicopia Remarks, *supra* note 9. See also Hall & Lehr, Rescuing Competition, *supra* note 35, at 7 ("[A] business will gain by disabling its rivals and making itself a monopolist.").

86. Yochi J. Dreazen & Andy Pasztor, *FCC Rejects EchoStar-Hughes Merger*, WALL ST. J., Oct. 11, 2002, at A3.

87. See News Release, Federal Communications Commission, FCC Chairman Powell Recommends Increased FCC Enforcement Powers for Local Telephone Competition (May 7, 2001), available at [http://www.gov/Bureau/Common\\_Carrier/News-Releases/2001/nrcc0116.html](http://www.gov/Bureau/Common_Carrier/News-Releases/2001/nrcc0116.html).

88. See Powell Senate Statement, *supra* note 9. Mr. Powell has made providing continuing service and restoring confidence the front line of his strategy. See *id.* at 16-17.

89. See News Release, Federal Communications Commission, FCC Declines to Approve EchoStar-DirecTV Merger (Oct. 10, 2002), available at [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC-229263A1.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-229263A1.pdf) [hereinafter FCC EchoStar/DirecTV Press Release].

90. For instance, a recent opinion essay offers an argument that the FCC was wrong in denying the EchoStar-DirecTV merger. See Malcolm Wallop, *Rural Americans? Want Broadband? Don't Ask the FCC*, WALL ST. J., Oct. 14, 2002, at A16.

91. See *infra* Part II.

92. See *infra* Part III.



## II. DISAGGREGATING THE LOCAL NETWORK

### A. Principles

#### 1. Economic Underpinnings

At their core, the local competition provisions of the Act are based on the premise that by disaggregating the monopolist's, or ILEC's, infrastructure, a workable competitive market for local telephony can develop. In other words, rather than regulating the retail rates—or “output”—of a monopolist, competitors should be allowed access to certain critical inputs that are costly to duplicate.<sup>93</sup>

The approach of regulating these “bottleneck” inputs rather than retail output makes eminent sense because it allows competition to flourish in the nonbottleneck portions of the network while protecting consumers from monopoly rents in the bottleneck portions. As Professor William Rogerson points out: “Regulating narrowly defined inputs instead of outputs is one approach regulators can use to attempt to confine regulation to as small a sphere as possible, and thereby allow the benefits of competition to infuse more segments of an industry.”<sup>94</sup>

The next question is whether this disaggregation model is viable in telecommunications. After all, there is the view, articulated recently by FCC Chairman Powell, that “facilities-based” competition—where a new entrant creates its own infrastructure—may be the only tenable form of competition.<sup>95</sup>

What this point of view ignores, however, are the prohibitive costs and inefficiencies engendered in duplicating infrastructure—especially the “last mile” of wires into a subscriber's home.<sup>96</sup> A recent OECD report points out

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93. This is part of a broader trend of regulation moving away from a purely rate-setting function and toward one that promotes competition. See, e.g., Joseph D. Kearney & Thomas W. Merrill, *The Great Transformation of Regulated Industries Law*, 98 COLUM. L. REV. 1323 (1998).

94. William P. Rogerson, *The Regulation of Broadband Telecommunications, the Principle of Regulating Narrowly Defined Input Bottlenecks, and Incentives for Investment and Innovation*, 2000 U. CHI. LEGAL F. 119, 135 (2000).

95. See Powell Communicopia Remarks, *supra* note 9.

96. See, e.g., LAFFONT & TIROLE, *supra* note 6, at 22. Note that one can argue that intermodal facilities-based competition is preferable—in other words, telephony, cable, wireless, and satellite each competing with their own facilities. The problem with this argument is two-fold. First, by limiting the debate to intermodal competition, this argument seems to ignore the possibility of *intramodal* competition—in other words, why restrict each mode to a monopolist? Second, there are currently only two modes of competition that are economically efficient in most areas: copper wire and coaxial cable—at least until advances dramatically improve the cost and functionality of the other technologies. As the OECD correctly points out, “considering the huge amount of investment required

that this is “the most expensive part of the telecommunications network, and it is not possible in the short to medium term for new entrants to have a ubiquitous network such as those of the incumbent.”<sup>97</sup> As Professor Jim Chen has succinctly pointed out, “no one seriously believes that any CLEC in the short run can duplicate an incumbent network from scratch.”<sup>98</sup> The fate of many facilities-based competitors bears out this point.<sup>99</sup>

Leading commentators have also emphasized the centrality of the interconnection requirement as a competitive paradigm.<sup>100</sup> Professor Eli Noam has even gone so far as to argue that interconnection becomes a proxy for common carriage: “In a competitive regime, *interconnection* rights will achieve most of the goals that lie behind common carriage. Interconnection rights, indeed, have become the major battleground in American telecommunications.”<sup>101</sup>

## 2. Statutory Language

Given the appeal of regulating bottleneck inputs through interconnection, the Act sought to offer guidance on two fundamental questions: what to disaggregate and at what price. Since the statutory language is basic to the remainder of this section, it is useful to lay out its key provisions.

to build a local loop, it seems that the incumbent’s dominance in the local loop will remain in the near future unless there is a technological breakthrough in wireless technology.” 2001 OECD Report, *supra* note 41, at 6.

97. See 2001 OECD Report, *supra* note 41, at 8. The report also points out that as opposed to long-haul backbone networks for long distance, last mile infrastructure is “subject to very strict local regulation and lengthy discussions with local authorities and private property owners to attain rights-of-way.” *Id.*

98. Jim Chen, *Standing in the Shadows of Giants: The Role of Intergenerational Equity in Telecommunications Reform*, 71 U. COLO. L. REV. 921, 932 (2000). See also Robert E. Hall & William H. Lehr, Promoting Broadband Investment and Avoiding Monopoly 8 (Feb. 21, 2002) (unpublished manuscript), available at <http://www.sandhillecon.com/hlpaper2/Broadband.pdf> (“In most locations, it is neither profitable nor economically efficient to build new circuits to homes at this time.”).

99. The Association of Local Telecommunications Services points out that there were only seventy facilities-based CLECs in operation in 2002, down from over 300 in 2000. See ALTS Annual Report, *supra* note 10, at 5. The FCC reports that 29% of CLEC local loops are facilities based, while 21% are resold and 50% are through unbundled network elements. See FCC Local Competition Report, *supra* note 36, Table 3. But note that most of the facilities-based providers serve businesses in large metropolitan areas. Furthermore, CLECs are unprofitable. See *supra* notes 10-13.

100. See, e.g., Eli M. Noam, *Will Universal Service and Common Carriage Survive the Telecommunications Act of 1996?*, 97 COLUM. L. REV. 955, 972 (1997) (“[T]he 1996 Telecommunications Act creates major interconnection rights and duties . . . . Once the dust settles it will be possible for all telecommunications carriers directly or indirectly to interconnect with one another as a matter of right.”); Howard A. Shelanski, *A Comment on Competition and Controversy in Local Telecommunications*, 50 HASTINGS L.J. 1617 (1999).

101. See Noam, *supra* note 100, at 956 (emphasis in original).

The Act outlined three ways to achieve ILEC network disaggregation under § 251. The first method is via interconnection where the ILEC has

[t]he duty to provide, for the facilities and equipment of *any requesting telecommunications carrier*, interconnection with the local exchange carrier's network—

(A) for the transmission and routing of telephone exchange service and exchange access;

(B) *at any technically feasible point* within the carrier's network  
 . . . .<sup>102</sup>

The second, and by far most controversial, method is for an ILEC to unbundle its network. This is a “duty to provide, to *any requesting telecommunications carrier* for the provision of a telecommunications service, nondiscriminatory access to network elements on an unbundled basis *at any technically feasible point . . .*”<sup>103</sup> Most importantly, in determining what network elements should be unbundled, the FCC must at least consider whether

(A) access to such network elements as are proprietary in nature is *necessary*; and

(B) the failure to provide access to such network elements would *impair* the ability of the telecommunications carrier seeking access to provide the services that it seeks to offer.<sup>104</sup>

The third, and least controversial way, is “to offer for resale at wholesale rates any telecommunications service that the [incumbent] carrier provides at retail to subscribers who are not telecommunications carriers.”<sup>105</sup>

Perhaps most significantly, Congress offered guidance on how to price interconnection and unbundling. According to the Act, “just and reasonable” rates

(A) shall be—

(i) based on the *cost* (determined without reference to a rate-of return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and

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102. 47 U.S.C. § 251(c)(2) (2002) (emphasis added).

103. 47 U.S.C. § 251(c)(3) (emphasis added).

104. 47 U.S.C. § 251(d)(2) (emphasis added).

105. 47 U.S.C. § 251(c)(4)(A).

(ii) nondiscriminatory, and

(B) may include a *reasonable profit*.<sup>106</sup>

Viewed in light of regulating bottleneck inputs and last-mile facilities, it would be difficult to join the bandwagon of critics who delight in critiquing the Act.<sup>107</sup> Rather, the Act's statutory language makes sense. It offers three logical approaches to the disaggregation model as well as pricing guidance that moves away from rate-based regulation. Yet, the Act does not seek to micromanage actual implementation. After all, it is not Congress' job to serve as a surrogate for an expert agency. Rather, in the words of one commentator, the approach "allows for continuing flexibility; as technology changes regulatory overseers can be quick to respond with the appropriate new changes."<sup>108</sup>

Unfortunately, the FCC poorly implemented the Act's guidance, especially as it relates to the "necessary" and "impair" standards in the unbundling and the pricing provisions. The result has been a protracted fiasco.

## B. The Unbundling Saga

### 1. Iowa Utilities Board Litigation

Pursuant to § 251 of the Act, the FCC formulated its First Report and Order to implement the local competition provisions.<sup>109</sup> A number of challenges were brought under these implementing regulations, and these were consolidated in the United States Court of Appeals for the Eighth Circuit.<sup>110</sup> Interpretation of the "necessary" and "impair" standards<sup>111</sup> was one critical element of this litigation.<sup>112</sup>

The FCC viewed the "necessary" standard as having been met even if "requesting carriers can obtain the requested proprietary element from a source other than the incumbent" because "requiring new entrants to duplicate unnecessarily even a part of the incumbent's network could

106. 47 U.S.C. § 252(d)(1) (emphasis added).

107. See *supra* notes 17-26.

108. Tim Rupp, Note, *The Effect of the Telecommunications Act of 1996 on the Local Exchange: A Significant Step in the Right Direction*, 70 S. CAL. L. REV. 1085, 1140 (1997).

109. *In re Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, 11 F.C.C.R. 15,499 (1996) (CC No. 96-98) [hereinafter First Report and Order].

110. *Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997).

111. See *supra* note 104.

112. The other central challenge was to the FCC's jurisdiction. For a detailed discussion, see *infra* Part IV.C.1.

generate delay and higher costs for new entrants.”<sup>113</sup> Further, a new entrant would be deemed “impaired” if “the failure of an incumbent to provide access to a network element would decrease the quality, or increase the financial or administrative cost of the service a requesting carrier seeks to offer, compared with providing that service over other unbundled elements in the incumbent’s [local exchange carriers] network.”<sup>114</sup>

While the Eighth Circuit Court of Appeals viewed these interpretations as reasonable under *Chevron* deference,<sup>115</sup> the Supreme Court disagreed. Writing for the majority, Justice Scalia pointed out that the FCC’s interpretation of the “necessary” standard is irrational since the FCC cannot “blind itself to the availability of elements outside the incumbent’s network.”<sup>116</sup> The Court also noted that the FCC’s interpretation of the “impairment” standard also does not pass muster because it is meaningless to posit that “any increase in cost (or decrease in quality) imposed by denial of a network element” impairs the “entrant’s ability to furnish its desired services.”<sup>117</sup>

The Court wrote that the FCC’s interpretation is akin to ignoring the “necessary” and “impair” provisions in the statute,<sup>118</sup> pointing out that the FCC’s own rule interpretation emphasizes the duty to unbundle under § 251(c)(3),<sup>119</sup> while treating the limitations on that duty under § 251(d)(2)<sup>120</sup> as merely a permissive “soften[ing] of that obligation by regulatory grace.”<sup>121</sup> The Court wrapped up this portion of the opinion with some harsh words for the FCC:

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113. First Report and Order, *supra* note 109, at 283.

114. *Id.* at 285.

115. 120 F.3d at 809-10. *See also* *Chevron U.S.A., Inc. v. Nat’l Res. Def. Council*, 467 U.S. 837 (1984). The fundamental contribution of *Chevron* is a two-part test:

When a court reviews an agency’s construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter . . . . If, however, the court determines Congress has not directly addressed the precise question at issue . . . the question for the court is whether the agency’s answer is based on a permissible construction of the statute.

*Id.* at 842-43 (emphasis added). *Chevron* has spawned a vast literature. For a recent detailed discussion of where the *Chevron* doctrine may or may not apply, see Thomas W. Merrill & Kristin E. Hickman, *Chevron’s Domain*, 89 GEO. L.J. 833 (2001).

116. *Iowa Utils. Bd.*, 525 U.S. at 389.

117. *Id.* at 389-90.

118. *Id.* at 390.

119. *See supra* note 103 and accompanying text.

120. *See supra* note 104 and accompanying text.

121. 525 U.S. at 391. *See also* Rebecca Beynon, *The FCC’s Implementation of the 1996 Act: Agency Litigation Strategies and Delay*, 53 FED. COMM. L.J. 27, 43-46 (2000) (arguing that the FCC erroneously read the § 251(c)(3) requirement into § 251(d)(2), and pointing to other instances where the regulatory agency “seems to have shot itself in the foot”).

*The Commission's premise was wrong.* Section 251(d)(2) does not authorize the Commission to create isolated exemptions from some underlying duty to make all network elements available. It requires the Commission to determine on a rational basis which network elements must be made available, taking into account the objectives of the Act and giving some substance to the “necessary” and “impair” requirements.<sup>122</sup>

In effect, the Supreme Court correctly vacated an agency interpretation that defies statutory language, legislative intent, and common sense.<sup>123</sup> But in doing so, two insights emerge. The first insight is that the judiciary saw fit to intervene in the rulings of an expert agency, where, one might argue, it counts: regarding the fundamental issue of what should be unbundled.<sup>124</sup> This has spawned an interesting debate as to whether the Court actually applied *Chevron* deference or crafted its own flavor of the nondelegation doctrine.<sup>125</sup>

The second insight is that despite its intervention, the Supreme Court does not have the institutional competence or authority to fashion a new rule; at best it can remand to the agency for reformulation. Thus, even though a generalist judiciary might have an excellent intuitive feel as to where the regulatory problems are, it cannot supplement the expert agency. The ultimate responsibility rests with the FCC.

## 2. *The FCC Redux*

Unfortunately, after the *Iowa Utilities Board* litigation, the FCC disappointed once again, developing a byzantine set of new regulations. It redefined “impairment” to require unbundling if, “taking into consideration the availability of alternative element outside the incumbent’s network, including self-provisioning by a requesting carrier or acquiring an alternative

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122. 525 U.S. at 391-92 (emphasis added).

123. Indeed, some leading commentators have lamented the “FCC’s blindness to the costs of mandatory unbundling.” Thomas M. Jorde et al., *Innovation, Investment, and Unbundling*, 17 YALE J. ON REG. 1, 4 (2000).

124. Contrast this to the Court’s later position on the second fundamental issue: At what price an element should be unbundled. See *infra* Part II.C.3.

125. For a survey of challenges to the *Chevron* regime, including one that contemplates *Iowa Utilities Board* as an indication of a return to the nondelegation doctrine, see Philip J. Weiser, *Federal Common Law, Cooperative Federalism, and the Enforcement of the Telecom Act*, 76 N.Y.U. L. REV. 1692, 1721-26 (2001). See also Lisa Schultz Bressman, Essay, *Schechter Poultz at the Millenium: A Delegation Doctrine for the Administrative State*, 109 YALE L.J. 1399 (2000). For a broader consideration of whether agency enabling statutes should be viewed as charters, constitutions, or sources of common law norms, see Lars Noah, *Interpreting Agency Enabling Acts: Misplaced Metaphors in Administrative Law*, 41 WM. & MARY L. REV. 1463 (2000).

from a third-party supplier, lack of access to that element materially diminishes a requesting carrier's ability to provide the services it seeks to offer."<sup>126</sup>

In addition, the regulations now pointed to several factors to determine the availability of alternative network elements<sup>127</sup> under the new "impairment" standard. As if this were not complicated enough, the new regulations directed the FCC to also look beyond "impairment" to determine whether to unbundle a network element.<sup>128</sup>

Following ILEC challenges, the United States Court of Appeals for the District of Columbia Circuit vacated the new rules.<sup>129</sup> The court determined that the FCC's uniform, national standard did not take into account the state of competition in the actual market.<sup>130</sup> The court also rejected each of the FCC's five rationales for the rule.<sup>131</sup> The D.C. Circuit summarized by chastising the FCC:

In the end, then, the entire argument about expanding competition and investment boils down to the Commission's expression of its belief that in this area more unbundling is better. But . . . *we believe it must point to something a bit more concrete than its belief in the beneficence of the widest unbundling possible.*<sup>132</sup>

During February 2003, the FCC attempted to begin resolving the issue for a third time,<sup>133</sup> but its new set of complex rules may well exacerbate the situation. The rules first state that unbundling is generally not required when serving business customers.<sup>134</sup> For residential customers, state commissions

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126. FCC Common Carrier Services, 47 C.F.R. § 51.317(b)(1) (2001).

127. The factors include cost, effect on timeliness of entry, quality, ubiquity, and impact on network operations. *See* 47 C.F.R. § 51.317(b)(2).

128. These additional factors are whether unbundling would lead to "rapid introduction of competition"; promote "facilities-based competition, investment, and innovation" or "reduced regulation"; or be "administratively practical to apply." *See* 47 C.F.R. § 51.317(b)(3).

129. *U.S. Telecom Ass'n v. FCC*, 290 F.3d 415 (D.C. Cir. 2002).

130. *Id.* at 421-26.

131. *Id.* at 426-28.

132. *Id.* at 425 (emphasis added). In addition, the D.C. Circuit vacated another FCC rule that unbundled the high-frequency portion of copper loops based on the premise that there is sufficient competition from cable and wireless. *Id.* at 428-30. This ruling could hinder CLECs in their efforts to provide DSL services and is related to the broader debate over whether DSL is an information service or a telecom service. *See Most Commenters Urge FCC to Apply Unbundling to Bell DSL*, LOC. COMPETITION REP., July 15, 2002. *See also* Christopher Stern, *U.S. Court Undercuts Rivals to Baby Bells; Selling Network Access Cannot Be Required*, WASH. POST, May 25, 2002, at E1.

133. *See* News Release, Federal Communications Commission, FCC Adopts New Rules for Network Unbundling Obligations of Incumbent Local Phone Carriers (Feb. 20, 2003), *available at* [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC-231344A1.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-231344A1.pdf).

134. More specifically, the rules create a presumption against unbundling high-capacity business loops, but this presumption is rebuttable by the states. *See* Federal Communications Commission,

are left to decide what elements should be unbundled, except that a competitor cannot provide DSL service by unbundling only a portion of an incumbent's loop.<sup>135</sup>

A few things are extraordinary about this decision, especially in light of past failed attempts. The first is how sharply divided the FCC commissioners are—one commissioner has summarized it as a “split decision plagued by shifting pluralities.”<sup>136</sup> In particular, there seems to be significant tension between Chairman Powell and Commissioner Kevin Martin.<sup>137</sup> Beyond reports of clashing personalities,<sup>138</sup> the new guidance appears to ignore major issues. It seems merely to deflect the difficult questions to state public utility commissions rather than offering them greater guidance.<sup>139</sup> Moreover, not allowing unbundling for DSL will likely deal a severe blow to broadband

Attachment to Triennial Review Press Release (Feb. 20, 2003), available at [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC-231344A2.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-231344A2.pdf).

135. See *id.* In other words, a new entrant would have to pay for the lower frequencies, which provide voice transmission, since it is now unable to use merely the high frequency portion to provide broadband. In addition, there is no unbundling requirement for an incumbent's fiber/copper hybrid loops or for the small number of fiber loops that run directly to homes. See *id.*

136. News Release, Commissioner Michael J. Copps, Approving in Part, Concurring in Part, Dissenting in Part, *Re Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers* (Feb. 20, 2003), available at [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC-231344A5.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-231344A5.pdf).

137. Chairman Powell had wanted to remove the unbundling obligation *in toto*, and early press reports suggested he would be victorious. See, e.g., Yochi J. Dreazen & Shawn Young, *FCC Plans to Erase a Key Rule Aiding Local Phone Competition*, WALL ST. J., Jan. 6, 2003, at A1. However, as the decision approached, Commissioner Martin, a Republican, sided with the two Democratic Commissioners, Copps and Adelstein, in a 3 to 2 decision over Chairman Powell and Commissioner Abernathy. See, e.g., Yochi J. Dreazen, *Powell Faces Threat from Within FCC*, WALL ST. J., Feb. 24, 2003, at A4; Reinhardt Krause, *Split FCC Snubs Chief, Keeps Bell Oversight Mostly in State Hands*, INV. BUS. DAILY, Feb. 21, 2003, at A1.

138. Direct hints of strife are also provided in Commissioners' public statements. For example, Commissioner Copps wants everyone to “take a deep breath, nourish a collaborative dialogue, lower the decibel level and, finally, try to pull together to make some progress.” *Health of the Telecommunications Sector: Hearing Before the Subcommittee on Telecommunications and the Internet, House Committee on Energy and Commerce* (Feb. 26, 2003) (statement of Michael J. Copps, Commissioner, Federal Communications Commission), available at [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC-231559A1.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-231559A1.pdf). Commissioner Adelstein observes that “[h]aving this proceeding in my first three months was quite a baptism by fire. I feel like I'm ready for just about anything now.” News Release, Commissioner Jonathan S. Adelstein, Approving in Part, Concurring in Part, Dissenting in Part, *Re Review of Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers* (Feb. 20, 2003), available at [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC-231344A8.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-231344A8.pdf).

139. Perhaps the FCC gave power to the states to address the D.C. Circuit's concern over a uniform, national standard. See *supra* note 130. However, the FCC does not seem to give state officials further help as to what to do. See also *Health of the Telecommunications Sector: Hearing Before the Subcommittee on Telecommunications and the Internet, House Committee on Energy and Commerce* (Feb. 26, 2003) (statement of Kathleen Q. Abernathy, Commissioner, Federal Communications Commission), available at [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC-231535A2.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-231535A2.pdf).



competitors who are not players in voice telephony.<sup>140</sup> Finally, by apparently taking the current flowed pricing mechanism for granted, the Commission has missed an opportunity to deal squarely with the pricing issue.<sup>141</sup> Chairman Powell, in a scathing dissent, has even suggested that the rules will not withstand judicial scrutiny and that this will be “strike three” for the FCC.<sup>142</sup>

To summarize this almost sordid tale: Congress developed unbundling provisions based on sound economic principles, but the FCC has repeatedly been unable to develop rational implementing regulations. The judiciary has the instinct to be able to “sniff out” the problem, but it obviously cannot do the FCC’s job for it. We are therefore left at an impasse.

### 3. *Proposed Approach*

The issue of what to unbundle is hardly as intractable a problem as the preceding litigation would make it appear. Indeed, had the FCC relied on basic economic principles, it could have avoided a lot of the litigation.

Under general antitrust principles, even a monopolist can refuse to deal with rivals. One important exception, however, is the essential facilities doctrine developed at common law.<sup>143</sup> The doctrine essentially states that under certain circumstances, a refusal to deal is subject to a monopolization claim under section 2 of the Sherman Act.

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140. Another perverse consequence of the ruling is that RBOCs will likely slow their investment in DSL and fiber to the home. The emerging argument is, given that RBOCs are still subject to general unbundling requirements, they lack the profits to invest in new technologies. *See, e.g.,* Julia Angwin & Dennis K. Berman, *Local-Phone Giants Back Off on Promise to Invest in Broadband Despite Winning a DSL Ruling*, WALL. ST. J., Feb. 21, 2003, at B1.

141. *See infra* Part II.C for a discussion of pricing.

142. *See* News Release, Chairman Michael K. Powell, Dissenting in Part, *Re Review of Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers* (Feb. 20, 2003), *available at* [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC-231344A3.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-231344A3.pdf) (“The legal errors of today’s decision are many to my mind. . . . In choosing to abdicate its responsibility to craft clear and sustainable rules unbundling to the State Public Utility Commissions the Majority has brought forth a molten morass or regulatory activity that may well wilt any lingering investment interest in the sector.”). A few days later, Chairman Powell echoed the same themes before Congress. *See Health of the Telecommunications Sector: Hearing Before the Subcommittee on Telecommunications and the Internet, House Committee on Energy and Commerce* (Feb. 26 2003) (statement of Michael K. Powell, Chairman, Federal Communications Commission), *available at* [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC-231535A1.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC-231535A1.pdf) (“[T]here seems to be no logical federal policy driving the Commission’s decision. . . . I fear the Commission may soon find itself in the embarrassing position of having its unbundling regime vacated for a third time.”).

143. For a review of the essential facilities doctrine, *see* Abbott B. Lipsky, Jr. & J. Gregory Sidak, *Essential Facilities*, 51 STAN. L. REV. 1187 (1999); Robert Pitofsky, *The Essential Facilities Doctrine Under United States Law* (2002), *at* <http://www.ftc.gov/os/comments/intelpropertycomments/pitofskyrobert.pdf>.

In *MCI Communications Corp. v. AT&T Co.*,<sup>144</sup> the United States Court of Appeals for the Seventh Circuit developed a four-part test to invoke the essential facilities doctrine that requires a showing of “(1) control of the essential facility by the monopolist; (2) a competitor’s inability practically or reasonably to duplicate the essential facility; (3) the denial of the use of the facility to a competitor; and (4) the feasibility of providing the facility to competitors.”<sup>145</sup>

Thus, rather than litigating complex, ad hoc implementing rules, the FCC could fashion its implementing regulations on this doctrine to force unbundling only of essential facilities.<sup>146</sup> As Professor John Soma points out:

Infusing essential facilities principles within section 251 of the 1996 Act creates investment incentives and ensures a competitive marketplace by mandating interconnectivity, resale, and unbundling at competitive rates only when a monopolist denies access to a facility essential to competition in the local telecommunications market that cannot be practically duplicated by a competitor.<sup>147</sup>

Some distinguished economists have even developed specific refinements to the essential facilities doctrine in the context of local competition. Most significantly, Hausman and Sidak have enhanced the four-part essential facilities doctrine by adding a fifth requirement “based on critical share, that examines whether an attempt by the ILEC to deny the CLEC access to the element in question would decrease the competition in the output market for telecommunications services.”<sup>148</sup> In a somewhat similar vein, Pablo Spiller has developed a three-part test, which he has presented in the European telecommunications context.<sup>149</sup>

144. 708 F.2d 1081 (7th Cir. 1983).

145. *Id.* at 1132-33.

146. Nothing in the 1996 Act precludes such an application. See Glen O. Robinson, *On Refusing to Deal with Rivals*, 87 CORNELL L. REV. 1177, 1220 (2002) (“Perhaps Congress did not specifically intend to invoke the essential facilities doctrine, but nothing in the statute precludes its application.”).

147. John T. Soma et al., *The Essential Facilities Doctrine in the Deregulated Telecommunications Industry*, 13 BERKELEY TECH. L.J. 565, 613 (1998). See also Elizabeth A. Nowicki, Note, *Competition in the Local Telecommunications Market: Legislate or Litigate?*, 9 HARV. J.L. & TECH. 353, 364 (1996) (“In the local telecommunications market after deregulation . . . it is more appropriate to apply the ‘essential facilities doctrine’ . . . .”); Robinson, *supra* note 146, at 1217-23 (discussing essential facilities in the context of local telephone competition). For a discussion of how essential facilities may be a better approach than tying in antitrust enforcement in high technology networks, see Thomas A. Piraino, Jr., *An Antitrust Remedy or Monopoly Leveraging by Electronic Networks*, 93 NW. U. L. REV. 1 (1998).

148. Jerry A. Hausman & J. Gregory Sidak, *A Consumer-Welfare Approach to the Mandatory Unbundling of Telecommunications Networks*, 109 YALE L.J. 417, 505 (1999). For a fuller description of the Hausman-Sidak test, see *id.* at 479-80.

149. Spiller’s three questions are as follows: “Do competitors build their own networks? Has

Even the Supreme Court has dropped hints, which the FCC has mysteriously ignored. In the *Iowa Utilities Board* opinion, Justice Scalia cautioned that:

We need not decide whether, as a matter of law, the 1996 Act requires the FCC to apply *that* [essential facilities] standard; it may be that some other standard would provide an equivalent or better criterion for the limitation upon network-element availability that the statute has in mind. But we do agree with the incumbents that the Act requires the FCC to apply *some* limiting standard, rationally related to the goals of the Act, which it has simply failed to do.<sup>150</sup>

Perhaps most tellingly, in his concurrence, Justice Breyer specifically refers to the fact that the essential facilities doctrine could apply to § 251(d)(2),<sup>151</sup> and goes on to add the following profound insight:

Increased sharing by itself does not automatically mean increased competition. *It is in the unshared, not in the shared, portions of the enterprise that meaningful competition would likely emerge.* Rules that force firms to share *every* resource or element of a business would create not competition, but pervasive regulation, for the regulators, not the marketplace, would set the relevant terms.<sup>152</sup>

In fact, Justice Breyer's suggestion gets to the heart of the Act's attempt to regulate critical inputs narrowly:<sup>153</sup> regulate only the network elements that are essential bottlenecks and allow competition to flourish everywhere else. Otherwise, the whole concept of competition becomes meaningless; after all, on what basis is there to compete if everything is unbundled?<sup>154</sup>

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unbundling of that network element been crucial for the development of facilities-based competition in other countries? Can the element to be unbundled only be effectively duplicated at a very high expense, and if so, can only a small number of the users served by that be captured by existing and potential entrants?" See Pablo T. Spiller, *Value-Creating Interconnect Unbundling and the Promotion of Local Telephone Competition: Is Unbundling Necessary in Norway?*, Foundation for Research in Economics and Business Administration (SNF), Breiviken, Norway (Mar. 1998).

150. *Iowa Utils. Bd.*, 525 U.S. at 388.

151. *Id.* at 428 (Breyer, J., concurring).

152. *Id.* at 429 (Breyer, J., concurring) (first emphasis added).

153. See *supra* Part II.A.1.

154. For a discussion on how this relates to the spate of CLEC bankruptcies, see *infra* Part II.C.4.

### C. The Pricing Fiasco

#### 1. Overview

The price at which to unbundle ILEC network elements has also been a subject of great interest and frustration.<sup>155</sup> Pricing, however, is central to the effectiveness of any regulation. As Professor Eli Noam points out, the interconnection debate “is primarily a battle over prices and who can set them.”<sup>156</sup> Given that the concept of moving away from retail rate regulation toward the regulation of bottleneck inputs is a relatively new idea,<sup>157</sup> economists still disagree on how to price access. At its core, the challenge is to set a price that is low enough to encourage new entrants, but high enough to encourage the incumbent to invest in the network.<sup>158</sup> Striking this balance is the fundamental challenge.

#### 2. The Conventional Wisdom: TELRIC

##### a. FCC Endorsement

The FCC has determined that pricing should be determined using a concept known as “forward-looking economic costs.” More specifically, regulations define this as the “sum of: (1) [t]he total element long-run incremental cost of the element [(TELRIC)] . . . ; and (2) [a] reasonable allocation of forward-looking common costs . . . .”<sup>159</sup> Common costs, in turn, are defined as costs “incurred in providing a group of elements or services . . . that cannot be attributed directly to individual elements or services.”<sup>160</sup>

155. See, e.g., Doane, *supra* note 21, at 312 (“How to set the prices paid by competitive local exchange carriers for the [unbundled network elements] of local exchange carriers has become perhaps the most contentious issue arising under the Act.”); Robinson, *supra* note 146, at 1222 (“Commentators have debated the pricing issue endlessly.”).

156. Noam, *supra* note 100, at 972. See also Salvatore Massa et al., *Pricing Network Elements under the Telecommunications Act of 1996: Back to the Future*, 23 HASTINGS COMM. & ENT. L.J. 751, 786 (2001) (“The critical element that will determine competition in a regime that encourages access to an incumbent’s facilities is determining the appropriate price.”).

157. See *supra* Part II.A.1. For a history of rate regulation and court responses to it, see *Verizon Communications, Inc. v. FCC*, 535 U.S. 467 (2002) (No. 00-511, 2001 Term), slip op. at 3-15.

158. See, e.g., 2001 OECD Report, *supra* note 41, at 18 (“If interconnection charges are too high, it will discourage companies to enter the telecommunications market. On the contrary, if interconnection charges are too low and below real cost, the incumbent cannot recover its investment on networks and both the incumbent and new entrants will be discouraged to make future investments in infrastructure.”); *Hold the Line: Connecting American Homes to the Internet Requires Strong Regulatory Nerves*, THE ECONOMIST, Dec. 12, 1998, at 20.

159. FCC Common Carrier Services, 47 C.F.R. § 51.505(a) (2001).

160. 47 C.F.R. § 51.505(e)(1).

Most significantly, TELRIC “should be measured based on the use of the *most efficient telecommunications technology currently available and the lowest cost network configuration*, given the existing location of the [ILEC]’s wire centers.”<sup>161</sup> In other words, TELRIC is based on the incremental cost of a hypothetical network that is maximally efficient.

*b. Fundamental Problems*

There are at least two fatal problems with this methodology: its cost basis is too low, and it ignores existing cross-subsidies in telecommunications regulation. With regard to cost, pricing access at the incremental cost of the most efficient network will simply “not allow the operator to make a margin on its bottleneck segment.”<sup>162</sup> A corollary to this reality is that an ILEC will have no incentive to invest in new network facilities if the resulting savings must be shared with competitors.

For their part, new entrants will not want to invest because it is cheaper for them to simply rent ILEC infrastructure at below-market rates. Professor Jerry Hausman has even pointed out that the TELRIC methodology in effect grants a “free option” to new entrants, since it ignores the fact that there are significant sunk costs in telecommunications infrastructure.<sup>163</sup> In other words, it will always be cheaper for CLECs to lease than to invest.<sup>164</sup> As Sidak and Spulber have pointed out, TELRIC “is a mantra that *misapprehends the most basic principles of price theory* . . . . [T]he FCC paints an incorrect portrait of how competitive pricing works.”<sup>165</sup> They have even argued that TELRIC violates the Takings Clause.<sup>166</sup>

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161. 47 C.F.R. § 51.505(b)(1) (emphasis added).

162. LAFFONT & TIROLE, *supra* note 6, at 173. See also Gary J. Guzzi, Note, *Breaking Up the Local Telephone Monopolies: The Local Competition Provisions of the Telecommunications Act of 1996*, 39 B.C. L. REV. 151, 193 (1997) (“The assumptions upon which TELRIC is based, practically speaking, can never be achieved. TELRIC assumes that the hypothetical [ILEC] always will be using the most efficient and most technologically advanced equipment at all times.”).

163. See Jerry A. Hausman, *The Effect of Sunk Costs in Telecommunications Regulation 3-4* (Oct. 1999) (unpublished manuscript), available at [http://econ-www.mit.edu/faculty/jhausman/files/Colum98\\_rev3.pdf](http://econ-www.mit.edu/faculty/jhausman/files/Colum98_rev3.pdf).

164. For the fallout from this reality, see *infra* Part II.C.4. Hausman’s prediction—written during the telecom boom years—that TELRIC “will likely have serious negative effects on innovation and new investment in the local telephone network” has proven quite prescient. See Hausman, *supra* note 163, at 1.

165. J. Gregory Sidak & Daniel F. Spulber, *Givings, Takings, and the Fallacy of Forward-Looking Costs*, 72 N.Y.U. L. REV. 1068, 1139 (1997) (emphasis added).

166. See J. Gregory Sidak & Daniel F. Spulber, *Deregulatory Takings and Breach of the Regulatory Contract*, 71 N.Y.U. L. REV. 851 (1996). For a time, the takings issue spawned its own literature. See, e.g., David Gabel & David I. Rosenbaum, *Who’s Taking Whom: Some Comments and Evidence on the Constitutionality of TELRIC*, 52 FED. COMM. L.J. 239, 253 (arguing that a taking has

To combat these allegations, some have offered modifications to cost-based pricing, such as using actual (as opposed to hypothetical) incremental costs.<sup>167</sup> Even if we assume, *arguendo*, that such approaches correct the cost basis, they do not address the second fundamental flaw with TELRIC pricing: namely, that any pricing methodology based uniquely on cost will be inaccurate in a world of hidden cross-subsidies where the actual cost of providing a service may have little to do with the amount that can be charged.<sup>168</sup> For example, residential service is subsidized, creating “retail price discrimination”: telephone companies can charge businesses higher prices even though the cost of providing such service is the same or even lower than it would be to serve a residence.<sup>169</sup>

In such an environment, TELRIC will create an arbitrage opportunity for new entrants: they will lease loops at hypothetical cost, but then only serve high-margin business customers.<sup>170</sup> For their part, ILECs will be left with a disproportionate number of low-margin residential customers, further impeding their ability to recover costs. Indeed, this is exactly what has happened.<sup>171</sup> Even some of the most eloquent TELRIC supporters pass quickly over this point. For example, Professors Hall and Lehr acknowledge the existence of “implicit subsidies” but simply posit that “prices should

not occurred); E. Sanderson Hoe & Stephen Ruscus, *Taking Aim at the Takings Argument: Using Forward-Looking Pricing Methodologies to Price Unbundled Network Elements*, 5 COMMLAW CONSPPECTUS 231 (1997) (arguing that a taking has not occurred). The Supreme Court put any such discussion to an end in *Verizon Communications v. FCC* by stating that it did not think a takings question was even at issue since the ILECs had failed “to present any evidence that the decision to adopt TELRIC was arbitrary, opportunistic, or undertaken with a confiscatory purpose.” 535 U.S. 467 (2002) (No. 00-511, 2001 Term), slip op. at 57.

167. See Massa, *supra* note 156, at 777-80.

168. See, e.g., Krattenmaker, *supra* note 23, at 130 (pointing to the “continuing conviction that markets for telecommunications services ought to be governmentally managed so that they provide—and to some extent conceal—pro-social cross-subsidies”).

169. See, e.g., Crandall & Sidak, *supra* note 10, at 358-59; Doane, *supra* note 21, at 318. Universal service—a fund to provide telephone services to low-income consumers, high-cost service areas, rural healthcare providers, and schools and libraries—is another example of a cross-subsidy. See, e.g., Universal Service Fund, at <http://www.fcc.gov/org/orgaudpm-usf.html>.

170. According to the latest FCC statistics, business lines are twice as costly to end-users as residential lines. The average residential monthly rate in urban areas is \$21.84 (with a \$42.72 connection charge). See FCC SOCC Report, *supra* note 5, Table 5.6. On the other hand, the average rate for a business with a single line is \$42-45 (with a \$72 connection charge). See *id.*, Table 5.7.

171. See, e.g., *supra* note 61. See also Kathy Brister, *FCC: Local Phone Competition Lags*, ATLANTA J. & CONST., May 29, 2002, at 1D (“Most competition has been for business customers, which are more lucrative than residential customers.”); Kosseff, *supra* note 67 (“Most of the competitors’ customers are businesses because telephone companies charge them more money per line—making them more attractive to competitors.”); Krause, *supra* note 26 (“Most telecom start-ups target small and midsize businesses, not residences.”); Rosenbush & Elstrom, *supra* note 67 (“[M]ost of the customers who have benefited are corporations, not residential customers.”).

reflect costs.”<sup>172</sup> Clearly, this is not realistic in a political regime replete with cross-subsidies.

*c. Support Persists*

What is perplexing is that despite these inherent problems with the methodology, many well-known economists apparently support it. For example, in his book *Telecommunications Competition*, Professor Ingo Vogelsang writes: “The endorsement in the FCC’s order for those principles substantially widens the consensus that forward-looking, long run incremental costs of complete services and network elements are the appropriate basis for efficient pricing.”<sup>173</sup> Professors Hall and Lehr similarly praise the FCC: “The FCC has developed a concept of cost, [TELRIC], that approximates the economist’s concept of cost suitable for setting the price at which a Bell should be required to sell network elements.”<sup>174</sup>

Other commentators also seem to support TELRIC<sup>175</sup> despite recognizing its inefficiencies.<sup>176</sup> But arguably the reason that the methodology has garnered the FCC’s support is that Professor William Baumol has supported TELRIC. Not only is Professor Baumol an extremely well-respected economist with the ear of regulatory bodies,<sup>177</sup> but Professor Baumol at one point developed an alternative to TELRIC, which, as Part II.C.5 discusses,

172. Hall & Lehr, *Rescuing Competition*, *supra* note 35, at 26. Interestingly enough, they also write that “[c]ompetition in long distance services has been vigorous because the Bells have been quite willing to sell access services to long-distance carriers at a regulated price that remains well above its cost.” *Id.* at 5. This is hard to square with their defense of TELRIC. After all, if policy dictates vigorous competition in local competition, unbundling prices should similarly allow the ILECs a profit. Perhaps because they are denied adequate profit, ILECs have resorted to litigation and paying fines. *See infra* Part II.D.

173. VOGELSANG & MITCHELL, *supra* note 6, at 245.

174. Hall & Lehr, *Rescuing Competition*, *supra* note 35, at 19. *See also* Hall & Lehr, *Promoting Broadband Investment*, *supra* note 98, at 10 (“If priced at long run incremental cost, the availability of unbundled network access provides efficient investment incentives to both entrants and the Bells.”).

175. *See, e.g.*, Chen, *Standing in the Shadows*, *supra* note 98, at 931-38 (arguing that it is “stultifyingly simple” that ILECs should not be able to recover for “stranded costs”); Gabel & Rosenbaum, *supra* note 166, at 268 (“TELRIC pricing allows efficient entry because competitors can obtain access to the network at a price that reflects the cost to society of making the resources available.”); 2001 OECD Report, *supra* note 41, at 19 (noting the “general consensus” that has emerged around the “theoretical superiority” of long-run incremental cost methodologies).

176. For a particularly original defense of TELRIC, see Ashutosh Bhagwat, *Unnatural Competition?: Applying the New Antitrust Learning to Foster Competition in the Local Exchange*, 50 HASTINGS L.J. 1479, 1498 (1999) (“Nonetheless, TELRIC pricing of network components may make sense because it is a way of encouraging entry in the face of fear of predation, and also a way of reducing the danger that the incumbent will engage in a supply squeeze or targeted predation against an entrant . . . . This is of course a somewhat unorthodox defense of TELRIC, suggesting as it does that on occasion TELRIC will induce *inefficient* (meaning higher-cost) entry.”).

177. *See, e.g.*, Kearney & Merrill, *supra* note 93, at 1402.

avoids many of TELRIC's pitfalls. Yet, as recently as 1998, Baumol concluded that: "[P]erhaps with some minor readjustment, the FCC's proposed standard—and indeed, one that is based even more exclusively on efficient costs—is entirely consistent with the competitive market model and with the forward-looking cost criterion for public interest pricing."<sup>178</sup>

Professor Baumol appears to have subsequently changed views; indeed, determining his actual opinion on the issue has become a bit of a *cause célèbre* in economic circles.<sup>179</sup> To summarize the TELRIC debate, and in the words of Sidak and Spulber: "[W]e argue that the FCC has fallen prey to several fallacies that make its version of pricing on the basis of forward-looking costs a tautology. We do not understand Baumol and Merrill, or other scholars of their stature, to endorse those fallacies of economic reasoning."<sup>180</sup>

### 3. *The Supreme Court's Interpretation*

#### a. *Majority Opinion*

Given the flaws in the TELRIC methodology, it should come as no surprise that the ILECs challenged it in court.<sup>181</sup> Recognizing the importance of the issue, the Supreme Court agreed to hear it<sup>182</sup> and delivered its opinion in *Verizon Communications, Inc. v. FCC*.<sup>183</sup>

In a detailed sixty-nine-page majority opinion, Justice Souter engaged in a careful discussion of various aspects of rate regulation and pricing, acknowledging that "competition in fact has been slow to materialize in local-exchange retail markets."<sup>184</sup> Despite this reality, the Court deferred to the FCC under *Chevron* and upheld TELRIC: "We cannot say whether the

178. William J. Baumol & Thomas W. Merrill, *Does the Constitution Require That We Kill the Competitive Goose? Pricing Local Phone Services to Rivals*, 73 N.Y.U. L. REV. 1122, 1147 (1998). See also William J. Baumol & Thomas W. Merrill, *Deregulatory Takings, Breach of the Regulatory Contract, and the Telecommunications Act of 1996*, 72 N.Y.U. L. REV. 1037, 1038 (1997) ("Most economists, joined by the FCC and the majority of state [public utility commissions], believe that rational decisions on the pricing of unbundled network elements and access to local networks must be based on forward-looking costs.").

179. In fact, the debate has apparently divided Baumol and Sidak, who had previously worked together on regulatory policy. See Jim Chen, *TELRIC in Turmoil, Telecommunications in Transition: A Note on the Iowa Utilities Board Litigation*, 33 WAKE FOREST L. REV. 51, 53 n.10 (1998).

180. Sidak & Spulber, *supra* note 165, at 1073.

181. See also *infra* Part II.D.

182. See Part II.B.1 and *supra* note 124.

183. 535 U.S. 467 (2002) (No. 00-511, 2001 Term). Note that this case is a continuation of the *Iowa Utilities Board* saga discussed *supra* Part II.B.1 and *infra* Part IV.C.1.

184. 535 U.S. 467 (2002) (No. 00-511, 2001 Term), slip op. at 50.



passage of time will show competition prompted by TELRIC to be an illusion, but TELRIC appears to be a *reasonable* policy for now, and that is all that counts.”<sup>185</sup>

It is critical to note that even though the Court may not have necessarily agreed with the FCC’s interpretation, it deferred to it by virtue of being a generalist judiciary:

Whether the FCC picked the best way to set these rates is the stuff of debate for economists and regulators versed in the technology of telecommunications and microeconomic pricing theory. *The job of judges is to ask whether the Commission made choices reasonably within the pale of statutory possibility* in deciding what and how items must be leased and the way to set rates for leasing them. The FCC’s pricing and additional combination rules survive that scrutiny.<sup>186</sup>

#### *b. Justice Breyer’s Dissent*

In dissent, Justice Breyer argued that there was no “rational connection” between the FCC’s regulations and the Act’s deregulatory purpose.<sup>187</sup> He perceptively criticized TELRIC along the lines of the economic arguments outlined above,<sup>188</sup> namely, that it reduces incentives for new entrants to invest,<sup>189</sup> and that an incumbent will not want to share cost-reducing investments with competitors.<sup>190</sup> In particular, Justice Breyer highlighted that “prices like the Commission’s, based on the costs that a *hypothetical* ‘most efficient’ firm would incur if *hypothetically* building largely from scratch . . . [would create] incentives that hinder rather than further the statute’s basic objective.”<sup>191</sup>

185. *Id.* at 52 (emphasis added). *Cf.* *WorldCom, Inc. v. FCC*, 308 F.3d 1, 7 (D.C. Cir. 2002) (“The FCC need not choose the ‘optimal’ benchmark, only a reasonable one.”); *SBC Communications, Inc. v. FCC*, 138 F.3d 410, 421 (D.C. Cir. 1998) (“Congress quite clearly gave the Commission the primary responsibility to make delicate judgments under this statute and we may not presume that the Commission will perform that task in bad faith.”); *W. Union Int’l, Inc. v. FCC*, 804 F.2d 1280, 1292 (D.C. Cir. 1986) (“The FCC’s judgment about the best regulatory tools to employ in a particular situation is . . . entitled to considerable deference from the generalist judiciary.”).

186. 535 U.S. 467 (2002) (No. 00-511, 2001 Term), slip op. at 69 (emphasis added).

187. *Id.* at 4 (Breyer, J., dissenting).

188. *See supra* notes 162-72.

189. 535 U.S. 467 (2002) (No. 00-511, 2001 Term), slip op. at 12-14 (Breyer, J., dissenting).

190. *Id.* at 14-15 (Breyer, J., dissenting).

191. *Id.* at 12 (Breyer, J., dissenting). *See also* Crandall & Sidak, *supra* note 10, at 407 (“In short the FCC’s action and inaction . . . suggested that the agency consciously sought to stimulate competitive entry into local telephony by encouraging (or commanding, if the courts would permit) the state [public utility commissions] to set prices and resale discounts that would not fully compensate the ILECs for their forward-looking common costs of local interconnection.”).

Finally, Justice Breyer highlighted his belief in a more active role for the judiciary: “[R]eview by generalist judges is important, both because technical agency decisions are often of great importance to the general public and because the law forbids agencies, in the name of technical expertise, to wrest themselves free of public control.”<sup>192</sup> While Justice Breyer’s point about judicial oversight is well taken, few judges will have the necessary expertise to be able to question the gamut of administrative agencies.<sup>193</sup> In pricing, as in the unbundling discussion above,<sup>194</sup> we have a generalist judiciary able to identify the key issues but unable to do the FCC’s job for it. Implicit in *Chevron* deference is the notion of institutional competence.

#### 4. *Economic Effects*

The FCC has thus promulgated a flawed pricing methodology. The Supreme Court intuitively realized the importance of the issue, but a majority deferred to the agency. Needless to say, this context is not conducive to competitive vigor and innovation.

For their part, the RBOCs are faced with what Professor John Soma has dubbed a “Hobbesian” choice:<sup>195</sup> they can either not invest, or they can invest and have competitors “free ride” on their investments.<sup>196</sup> Indeed, the unbundling controversy is now prominent in analysts’ caution toward RBOCs as investment opportunities.<sup>197</sup>

The enormous irony, however, is that TELRIC pricing has hurt the companies it was specifically designed to encourage the most—CLECs. Professor Jerry Hausman provided an early formulation of this thesis, as follows: CLECs had an incentive to expand as fast as possible, but none were forced to create any type of competitive advantage because they were essentially playing with the “free options” TELRIC gives them.<sup>198</sup> CLECs thus spent a disproportionate amount of money on marketing without having a distinctive product to back it up. Professor Hausman concludes: “The result

192. 535 U.S. 467 (2002) (No. 00-511, 2001 Term), slip op. at 25 (Breyer, J., dissenting).

193. Justice Breyer is a notable exception, having taught administrative law for nearly thirty years.

194. See *supra* Part II.B.

195. Soma, *supra* note 147, at 609.

196. Thomas Jorde and others have even proposed a mechanism based on intellectual property jurisprudence to avoid the free riding. See Jorde, *supra* note 123, at 10-11.

197. See, e.g., Merrill Lynch, The Telecommunicator: Telecom Act Seven Years On—The UNE Shock Wave Belatedly Reverberates Around the RBOCs—And How! (Sept. 23, 2002) [hereinafter Merrill Lynch Report]; UBS Warburg Global Equity Research, SBC Communications (Aug. 20, 2002). Overall, however, the ILECs are still better positioned than other telecommunications carriers, with approximately \$110 billion in revenues, and 30% operating margins. See FCC SOCC Report, *supra* note 5, Table 2.8. See also *id.*, Tables 2.9 & 4.

198. See Hausman, The Effect of Sunk Costs, *supra* note 163.

was increasingly large amounts of money spent on customer acquisition without a concomitant return now, or one expected in the future. The equity values of the broadband CLECs plummeted and capital market[s] closed. The result was bankruptcy.”<sup>199</sup>

This is congruent with Crandall and Sidak’s insight that “[a]n overly generous unbundling regime that rewards CLECs for deferring investment might be at the root of the CLECs’ problems.”<sup>200</sup> Even FCC Chairman Powell’s recent comments seem to corroborate the fact that CLECs had few (if any) competitive advantages; he lamented the fact that several telecommunications companies “amassed staggering amounts of debt in building *nearly-identical networks*.”<sup>201</sup> Unfortunately, regulatory policy has contributed significantly to this sorry state of affairs.<sup>202</sup>

A further twist to this tragedy is that large long distance carriers such as AT&T and Sprint have been the incidental beneficiaries of the CLECs’ demise; for instance, they have bought physical assets at “garage-sale prices.”<sup>203</sup>

199. Jerry A. Hausman, Competition and Regulation for Internet-Related Services: Current Competition and 3G in the Future? 31 (Oct. 4, 2001) (unpublished manuscript), *available at* [http://econ-www.mit.edu/faculty/jhausman/files/DSL3G\\_v5.pdf](http://econ-www.mit.edu/faculty/jhausman/files/DSL3G_v5.pdf).

200. Crandall & Sidak, *supra* note 10, at 335. Some critics place much of the blame on former FCC Chairman Reed Hundt. *See, e.g.,* Eisenbach, *supra* note 13 (“[Former FCC Chairman Hundt] believed that the way to inject competition into the local loop was to create a new breed of small, start-up telephone companies, and he consciously exploited the notoriously ambiguous Telecom Act to write regulations in their favor . . . . Mr. Hundt sent a crucial signal to the entire market—that government was prepared to do whatever it took to ensure their success. And so it did: From below-cost access to the incumbent carriers’ lines to an array of regulatory arbitrage opportunities, the FCC set out to create competition by creating, and supporting, competitors.”); Reinhardt Krause, “*Market Exuberance*” *One Factor in Failure of Telecom Start-Ups; Study Says FCC Played a Role; of 300 Local Phone Firms Existing, Three Years Ago, 70 Remained by Mid-02*, INVESTOR’S BUS. DAILY, Sept. 27, 2002, at A5 (noting that Hundt may have “put rules in place that led CLECs to expand too rapidly via leased lines . . . [and] didn’t do enough to encourage start-ups to build their own networks”).

201. Powell Senate Statement, *supra* note 9, at 8 (emphasis added).

202. In many respects this issue was repeated in the wireless arena, where the FCC tempted small bidders with favorable auction terms. These players also overreached and ended up bankrupt. *See* Pulley, *supra* note 8.

203. Steve Ulfelder, *The DLECs’ Demise Upstart DSL Providers Claim Dirty Tricks by Incumbents Contributed to Their Downfall; End Result Is That Customers Might Be Paying More and Waiting Longer for Broadband*, NETWORK WORLD, Jan. 7, 2002, at 34. *See also* Merrill Lynch Report, *supra* note 186, at 3 (“Now that the capital markets have effectively dried up for competitive telecom companies and many start-ups have filed for bankruptcy protection, there are only a handful of companies that are and will continue to use UNE-P [(unbundled network element-platform, a combination of UNEs)] in a material way in order to compete in the local loop . . . AT&T and WorldCom.”); Legg Mason, SBC Communications: AT&T Pleads Its UNE Case (Sept. 18, 2002).

## 5. Proposed Approach

### a. Overview

The bad news is that economically inefficient pricing is fairly common in telecommunications. The good news is that leading economists have developed microeconomic techniques to analyze the inefficiencies and offer new solutions in a variety of contexts.<sup>204</sup> Indeed, there are a number of pricing mechanisms that would avoid many of TELRIC's problems, including lowering termination charges rather than local loop charges<sup>205</sup> or utilizing binding arbitration conducted by an independent arbitration body unconnected to regulators.<sup>206</sup>

The most likely candidate to address the pricing woes, however, is the Efficient Component Pricing Rule (ECPR).<sup>207</sup>

### b. Methodology

At its core, ECPR is based on the concept of parity pricing or competitive neutrality, first articulated by Robert Willig<sup>208</sup> and later applied to telecommunications by William Baumol.<sup>209</sup> Its central idea is that an

204. See, e.g., Jerry Hausman, *Taxation by Telecommunications Regulation*, National Bureau of Economic Research Working Paper No. W6260 (Nov. 1997), available at <http://papers.nber.org/papers/w6260.pdf> (using public finance analysis to show that subsidizing Internet access for schools and libraries based on interstate telephone charges results in massive efficiency losses to the economy, in large part due to the "price elasticity of long distance service"); Jerry Hausman, *Efficiency Effects on the U.S. Economy from Wireless Taxation*, National Bureau of Economic Research Working Paper No. W7281, 14 (Aug. 1999), available at <http://papers.nber.org/papers/w7281.pdf> (providing a similar argument around the inefficiencies of current wireless taxation, adding that the "FCC and state regulatory authorities typically do not take into account efficiency effects on the economy from their regulatory actions"); J. Gregory Sidak & Daniel F. Spulber, *Cyberjam: The Law and Economics of Internet Congestion of the Telephone Network*, 21 HARV. J.L. & PUB. POL'Y 327 (1998) (arguing that the [public switched telephone network] will be used inefficiently as long as the FCC exempts ISPs from paying interstate access charges).

205. See, e.g., LAFFONT & TIROLE, *supra* note 6, at 208 ("It is more efficient to encourage competition through a low termination charge than through a low local loop rental charge. The former, unlike that latter, preserves a level playing field by not expropriating the incumbent.").

206. See Hausman, *Competition and Regulation*, *supra* note 199, at 29 n.54. Currently, if the incumbent and the new entrant cannot achieve resolution, then the pricing issue is referred to state regulators. See also *infra* note 359.

207. Obviously, settling the microeconomic debate is not within the scope of this part. The discussion that follows is meant to illustrate that the pricing issue can be addressed in a much more efficient manner than it has been to date.

208. See Robert D. Willig, *The Theory of Network Access Pricing*, in ISSUES IN PUBLIC UTILITY REGULATION 109 (Harry M. Trebbing ed., 1979).

209. See William J. Baumol, *Having Your Cake: How to Preserve Universal-Service Cross Subsidies While Facilitating Competitive Entry*, 16 YALE J. ON REG. 1, 4 (1999).

incumbent firm should not be penalized for being efficient and should be able to recoup the opportunity cost of not being able to sell or use the bottleneck input, itself. In other words, an incumbent should be able to price the bottleneck input by subtracting the cost of its nonbottleneck inputs from the total price it is charging today.

The principle essentially states that the bottleneck service<sup>210</sup> should be priced at the bottleneck owners' final price minus the incremental cost of supplying remaining inputs. What remains is the incumbent's opportunity cost, or foregone retail revenue. Mathematically, the formula is simply:

$$P_b = P_f - IC_r$$

where  $P_b$  is bottleneck price,  $P_f$  is final price, and  $IC_r$  is the incremental cost of the remaining inputs.

The power of ECPR is that it avoids the two fundamental problems of TELRIC: namely, an unrealistically low cost basis and the existence of cross-subsidies.<sup>211</sup> The first advantage is quite simple: ECPR is not based on hypothetical long-run incremental costs, but rather allows the incumbent to recover opportunity costs.

The second advantage concerning cross-subsidies is more subtle. ECPR should not funnel the vast majority of new investment to business customers just because the price charged to business customers is higher than the price charged to residential customers. Assuming the incremental cost of the remaining inputs is similar, the price to charge a new entrant for a bottleneck input to a residential customer will be lower than that to a business customer.<sup>212</sup> As a consequence, there should be no reason to discriminate against residential customers and "cream skim" business customers<sup>213</sup> by charging prices well above what it costs to serve them.<sup>214</sup>

210. Here, the bottleneck is the "last mile" of wires going into a consumer's home. Professor Baumol uses the example of a single railroad track along a mountain pass as an example of a transportation bottleneck. *See id.* at 10.

211. *See supra* Part II.C.2.b.

212. Or mathematically, if  $P_f$  is the price charged to a business customer and  $P_f'$  is that charged to a residential customer, then  $P_f > P_f'$ . If we assume that  $IC_r \sim IC_r'$ , then  $P_b > P_b'$ .

213. For a classic exposition on skimming as a pricing strategy, see Alan Reynolds, *A Kind Word for 'Cream Skimming'*, HARV. BUS. REV., Nov.-Dec. 1974, at 116. "Skimming" is often analyzed in contrast to "penetration," which involves pricing low to increase market share in competitive markets. *Id.*

214. Over the long run, if bottleneck input regulation is implemented correctly, then retail price regulation will no longer be necessary, since competition should flourish on the nonbottleneck portions of the network. Competition would offer not only price discipline, but also innovative products and services. *See also supra* notes 70-74.

Notwithstanding the controversy among economists, it is relatively safe to posit that those experts who specialize in microeconomic analysis of telecommunications advocate ECPR.<sup>215</sup>

*c. Potential Issues*

The ostensible reason why the FCC has not adopted ECPR is because the existing retail prices that would be used to compute incremental opportunity costs under ECPR are not cost-based.<sup>216</sup> The FCC presumably wants to be faithful to § 252(d)(1) of the Act, which requires that unbundling charges be “cost-based.”<sup>217</sup> However, this position is untenable for a number of reasons. First, by definition, ECPR does take incremental costs into consideration.<sup>218</sup> Second, § 252(d)(1) evinces Congress’ intent to move away from rate-of-return regulation, but otherwise leaves the definition of “cost” to the expert agency. As the Supreme Court pointed out in *Verizon Communications, Inc. v. FCC*: “[T]he word ‘cost’ in § 252(d)(1), as in accounting generally, is ‘a chameleon,’ a virtually meaningless term . . . . [W]ords like ‘cost’ ‘give ratesetting commissions broad methodological leeway; they say little about the ‘method employed’ to determine a particular rate.’”<sup>219</sup>

The more likely reason why the FCC did not adopt ECPR is that its principal developer, William Baumol, seemed to advocate against it.<sup>220</sup> Apparently, Professor Baumol seems to have recently changed his mind.<sup>221</sup> Indeed, some even speculate that Baumol’s support of TELRIC was based on a “critical cost assumption [that was] empirically unsupported”<sup>222</sup>—namely, that Baumol had underestimated the actual magnitude of the nonincremental costs that TELRIC ignores.<sup>223</sup>

Beyond this controversy, there are other potential problems with ECPR. For example, it does not take into account an incumbent’s fixed costs. The response to this is two-fold. First, one would presume that the incumbent

215. See J. Gregory Sidak & Daniel F. Spulber, *The Tragedy of the Telecommons: Government Pricing of Unbundled Network Elements under the Telecommunications Act of 1996*, 97 COLUM. L. REV. 1081, 1111-12 (1997). For a more extensive discussion of ECPR’s advantages, see WILLIAM J. BAUMOL & J. GREGORY SIDAK, TOWARD COMPETITION IN LOCAL TELEPHONY 116 (1994). For a discussion of the Baumol controversy, see *supra* note 179 and *infra* note 221.

216. First Report and Order, *supra* note 109.

217. See *supra* note 106.

218. See *supra* Part II.C.5.b.

219. 535 U.S. 467 (2002) (No. 00-511, 2001 Term), slip op. at 28-29 (citations omitted).

220. See *supra* notes 177-78.

221. See Baumol, *Having Your Cake*, *supra* note 209. See also Doane, *supra* note 21, at 314 (“The purpose of this Response is not to focus on Professor Baumol’s (welcome) change in position . . .”).

222. Sidak & Spulber, *The Tragedy of the Telecommons*, *supra* note 215, at 1138.

223. Notably, shared costs and common costs among network elements. See *id.*

would take into consideration its fixed costs and embed this into its price.<sup>224</sup> Second, as some commentators have suggested, an “end-user charge” can be added to ECPR<sup>225</sup> in a manner loosely analogous to the “common costs” added to TELRIC.<sup>226</sup>

Another issue is that an incumbent should not be able to maintain artificially high interconnection prices simply by maintaining an inefficient network. However, a modification to ECPR, M-ECPR, does address this issue: M-ECPR states that the price charged will be based on that of the most efficient competitor in the market.<sup>227</sup> In other words, if there is a more efficient competitor, then the incumbent will not be able to recover its full price.<sup>228</sup> Under M-ECPR, the incentive thus exists for the incumbent to invest in making its network at least as efficient as that of its competitor.

#### *d. Implications*

ECPR or M-ECPR might not be a “perfect” rule,<sup>229</sup> but it is substantially better than TELRIC. Unfortunately, many commentators lament the fact that regulatory agencies have not even invested the time to understand ECPR’s fundamentals. For instance, some lament “the FCC’s *unsophisticated caricature* of ECPR.”<sup>230</sup> Others even go so far as to point out that the FCC has a “*complete misunderstanding* of ECPR.”<sup>231</sup> Whether this is true or not is beside the point. What is critical is that the FCC’s economists begin to engage in a dialog regarding how its current pricing strategy may be

224. The incumbent would need to have reasonable granularity in its data on costs and capital expenditures. See VOGELSANG & MITCHELL, *supra* note 6, at 61.

225. See Doane, *supra* note 21, at 322-23; Sidak & Spulber, *The Tragedy of the Telecommons*, *supra* note 215, at 1085.

226. See *supra* note 159.

227. Mathematically, if the most efficient competitor’s cost for the bottleneck input is  $P_b''$  and  $P_b'' < P_b$ , then under M-ECPR,  $P_b$  assumes the value of  $P_b''$ .

228. See Doane, *supra* note 21, at 322; Sidak & Spulber, *The Tragedy of the Telecommons*, *supra* note 215, at 1093-96.

229. Some economists point to M-ECPR’s shortcomings, but they do not propose a workable alternative. See, e.g., Nicholas Economides, *The Tragic Inefficiency of the M-ECPR* (Dec. 1998), available at [raven.stern.nyu.edu/networks/tragic.pdf](http://raven.stern.nyu.edu/networks/tragic.pdf) (arguing that pricing should be based on social opportunity costs, rather than M-ECPR’s private opportunity costs, and concluding that ILECs will thus be able to charge inefficiently high prices). For a more nuanced discussion, including the fact that M-ECPR ironically may not be in the best interests of incumbents who are inefficient downstream from the input, see Dennis L. Weisman, *The Efficient Component Pricing Rule: Friend or Foe?* (May 2002), available at <http://www.ksu.edu/economics/weisman/ecpr.pdf>. Professor Weisman’s microeconomic analysis provides further support for the notion that M-ECPR will have the salutary effect of encouraging an incumbent to invest in its network to become efficient.

230. Sidak & Spulber, *The Tragedy of the Telecommons*, *supra* note 215, at 1138 (emphasis added).

231. Doane, *supra* note 21, at 315 (emphasis added).

fundamentally flawed.

Professors Laffont and Tirole have correctly observed that economists' "deregulatory fervor is often guided more by a gut feeling that competition is efficient than by a clear conceptual framework embodying the specificities of these industries."<sup>232</sup> If prices had been set using a coherent "conceptual framework," then perhaps the ongoing CLEC meltdown could have been mitigated, if not avoided.<sup>233</sup>

#### *D. One Good Deed Deserves Another: ILEC Reaction*

Before leaving the discussion of overly broad unbundling and inefficiently low pricing, it is worthwhile to discuss how ILECs, and in particular, RBOCs, have reacted. They have obviously engaged in a plethora of litigation, mostly to strike down poor implementing regulations.<sup>234</sup>

But the academic literature to date has not focused on another aspect of the RBOCs' behavior: quietly frustrating implementation and paying fines, almost as a cost of doing business. The local and trade press has chronicled a number of ways that ILECs have frustrated implementation: delaying repairs for CLEC customers,<sup>235</sup> not processing CLEC orders in an timely manner,<sup>236</sup> losing orders outright, or claiming there are no existing facilities with which to interconnect.<sup>237</sup> One competitor has even labeled it "success by incompetence" for the ILECs.<sup>238</sup>

Large fines have become routine.<sup>239</sup> The Association of Local

232. LAFFONT & TIROLE, *supra* note 6, at 2.

233. *See supra* Part II.C.4.

234. Professor Rob Frieden points out that "Congress underestimated the ability of stakeholders to maintain or create a competitive advantage by thwarting progress through litigation and through the exploitation of ambiguous statutory language." Rob Frieden, *Wither Convergence: Legal, Regulatory, and Trade Opportunism in Telecommunications*, 18 COMPUTER & HIGH TECH. L.J. 171, 178-79 (2002). While agreeing with Professor Frieden's overall point that players will try to "game" the system to their own advantage, it is important to note that the problem here is not the statutory language per se, but the regulations. In other words, the real question is whether Congress overestimated the capabilities of the FCC. *See also infra* notes 385-86.

235. *See, e.g.*, Johnson, *supra* note 2 (reporting that Ameritech takes 36 hours to fix repair problems for its own customers, but 100 to 120 hours to do repairs for [the CLEC's] customers).

236. *See, e.g.*, Sanford Nax, *Baby Bells Aiming Long: PUC Weighs SBC Bid to Offer Long-Distance Services*, THE FRESNO BEE, Jan. 13, 2002, at C1 (discussing accusations that Pacific Bell would delay order processing).

237. *See, e.g.*, Ulfelder, *supra* note 203 (discussing the "truckloads of [lost] orders" as well as one ISP director's reference to the Bells' "no facilities lie": "That's a 60-story high-rise in midtown Manhattan . . . You're telling us there's not another twisted pair available?").

238. *See id.* ILECs are also placing pressure on consumers; for example, by cutting off DSL service if they switch their local phone service to a new entrant. *See* Shawn Young, *New Phone Twist: Switch Local Service and Lose Your DSL*, WALL ST. J., Jan. 30, 2003, at B1.

239. Fines are based on measures to determine whether ILECs are offering competitors the same



Telecommunications Services has estimated ILEC fines that add up to \$1.8 billion between 1996 and 2001 and an additional \$3 billion in 2002.<sup>240</sup> But, as the *Boston Globe* points out, this may simply be a small cost of doing business:

Virtually every month brings news of the latest six- and seven-figure penalties paid by [the RBOCs]. Their offense: withholding or delaying access to their phone lines and switching stations [for a total penalty of] \$1.4 billion—including \$923 million from SBC alone—for poor service to rival phone companies and retail customers. It's a number that sounds big, but represents less than 1 percent of the Bell companies' combined 2001 revenues of \$156.9 billion. And what is impossible to estimate is how many dollars of business the Bells kept competitors from getting.<sup>241</sup>

Recently, a group of CLECs claimed that ILECs' anticompetitive actions violated a number of federal and state laws, including the Sherman Antitrust Act, the Telecommunications Act of 1996, state antimonopoly statutes, unfair competition laws, and state law breach of contract.<sup>242</sup> The United States Court of Appeals for the Eleventh Circuit overturned the district court's dismissal of the CLECs' action for failure to state a claim<sup>243</sup> and has allowed the case to proceed.<sup>244</sup>

The fact that so much of the lawsuit rests on antitrust and other common law could be interpreted as evincing a lack of faith in the FCC's ability to remedy the situation.<sup>245</sup> Perhaps it is no coincidence that one of the stated reasons FCC Chairman Powell is advocating facilities-based competition<sup>246</sup>

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level of service as their own retail operations. These include the number of days to connect lines, number of appointments missed, and other such factors.

240. See ALTS Annual Report, *supra* note 10, at 23. As just one example, the FCC has fined SBC \$6 million for violation of unbundling requirements in association with the Ameritech merger. See News Release, Federal Communications Commission, FCC Fines SBC Communications, Inc. \$6 Million for Violations of Commission Merger Condition (Oct. 9, 2002), available at [http://www.fcc.gov/Daily+Releases/Daily\\_Business/2002/db1010/DOC-227223A1.pdf](http://www.fcc.gov/Daily+Releases/Daily_Business/2002/db1010/DOC-227223A1.pdf).

241. Peter J. Howe, *Rivals Question Impact of Financial Penalties on Baby Bells*, BOSTON GLOBE, May 20, 2002, at C1. For an opinion piece on the subject by CLEC supporters, see Russell Frisby, Jr. & John D. Windhausen, Jr., *Telecommunications Bell Companies Thwart Local Competition*, CHARLESTON GAZETTE, Sept. 25, 2002, at P5A.

242. Covad Communications Co. v. BellSouth Corp., 299 F.3d 1272 (11th Cir. 2002).

243. See FED. R. CIV. P. 12(b)(6).

244. 299 F.3d at 1276.

245. Indeed, the Supreme Court has specifically agreed to determine whether private antitrust action can supplement claims against ILECs under the Act. See *Low Offices of Curtis V. Traho v. Bell Atlantic*, 294 F.3d 307 (2d Cir. 2002), cert. granted, 2003 U.S. LEXIS 1976 (U.S. Mar. 10, 2003) (No. 02-682).

246. See *supra* note 95.

is to lessen “dependency on an intransigent incumbent, who if committed to frustrate entry has a thousand ways to do so in small, imperceptible ways.”<sup>247</sup> But rather than throw in the towel, the FCC should try to reform its unbundling and pricing regulations using the techniques discussed in Parts II.B.3 and II.C.5, above.

For now, we have the following perverse situation: a group of incumbents are engaging in something akin to guerrilla warfare<sup>248</sup> to avoid a series of unbundling and pricing regulations that seemingly ignore basic economic principles. Given this sorry state of affairs, the lack of meaningful local competition should not be overly surprising.

### III. ALLOWING RBOCs TO COMPETE IN THE LONG DISTANCE MARKET

#### A. Overview

Entry into long distance presents a number of advantages for RBOCs. First, there is the opportunity to profit from a new business where infrastructure costs are lower than in local telephony.<sup>249</sup> Perhaps more importantly, it allows RBOCs to bundle services, which reduces both administrative overhead and customer churn.<sup>250</sup> The Act permits the RBOCs to enter the long distance market under certain conditions.

The overarching theory is to allow RBOCs into long distance only if local competition provisions are met. Section 271, which provides the statutory framework for RBOC entry into long distance, is in many ways a quid pro quo for § 251. While the latter provides a “stick” to prod the RBOCs to open the market to local competition, the former provides a “carrot” in the form of the long distance market in exchange for providing access to local bottlenecks. In the words of Professor Thomas Hazlett:

247. Powell Communicopia Remarks, *supra* note 9.

248. As Professors Hall and Lehr point out: “Not surprisingly, the Bells have resisted the interconnection mandates of the Act since its passage. The Bells have sought to delay implementation of the Act at every juncture.” Hall & Lehr, Promoting Broadband Investment, *supra* note 98, at 7.

249. As prices for long distance have decreased, margins have declined as well. Nonetheless, the cost of providing long distance service is anywhere from one to three cents per minute, depending on the network. See, e.g., Karen Kaplan & Christine Frey, *Long Distance May Face a Very Short Future; Telecom: Big Firms See Their Profits Fade as More Customers Go Wireless*, L.A. TIMES, Apr. 26, 2002, at A1. Given that costs are so low, any pricing above this level provides incremental profit.

250. See, e.g., Reinhardt Krause, *Bells on Brink of Going Long Distance; Many Approvals Expected Big Telecom Competition Is Set to Truly Arrive Soon in a Host of U.S. States*, INVESTOR’S BUS. DAILY, Aug. 2, 2002, at A4 (“The Bells can still make money, though. That’s because their new long-distance customers are already their local phone customers. So billing and other expenses are reduced.”).

The Telecommunications Act was the product of realpolitik. Reforms of the size and scope of the Act involve compromises and pork barrel bargains, such that an actual majority—or super-majority to circumnavigate the veto power of various interest groups and necessary committee chairs—can form a coalition to enact law.<sup>251</sup>

Reed Hundt, FCC Chairman at the time of the Act's passage, even mentions that one senator told him: "We gave one side everything they wanted, and then we gave the other side everything they wanted . . . . Good luck."<sup>252</sup> The statutory language, while overly formalistic as a result of all this give-and-take, does allow the FCC leeway to permit an RBOC to enter long distance only if there exists meaningful competition in local telephony. Unfortunately, the FCC again does not seem up to the task.

### B. Statutory Framework

The Act allows an RBOC to provide long distance<sup>253</sup> services from within its region<sup>254</sup> only if a series of four formal conditions are met.<sup>255</sup>

The first condition is meeting the requirements of what have been termed "Track A" or "Track B." Under "Track A," an RBOC must show that it has "entered into one of more binding agreements"<sup>256</sup> with new entrants for access to the incumbent's local telephone network. If a new entrant has not requested such access, or the access has not been approved,<sup>257</sup> then an RBOC can satisfy "Track B" by providing "a statement of the terms and conditions

251. Thomas W. Hazlett, *Economic and Political Consequences of the 1996 Telecommunications Act*, 50 HASTINGS L.J. 1359, 1389 (1999). See also Bhagwat, *supra* note 176, at 1479-80 ("[T]he Act sought to create incentives for LECs to cooperate in the development of local competition by offering the carrot that once the Bell Operating Company LECs complied with certain competition-permitting requirements, they would be permitted to enter into the long distance telephone market from which they had been long excluded."); Joseph Farrell, Speech, *Creating Local Competition*, 49 FED. COMM. L.J. 201, 211 (1996) (Speech of FCC Chief Economist Before the FCC (calling 271 the "long-distance entry carrot"); Sloan, *supra* note 7, at 312 ("Congress held out interLATA entry as a reward for the BOCs' acceptance of and compliance with interconnection, unbundling, and resale obligations designed to facilitate entry by alternative providers of local telecommunications services.")).

252. Rosenbush & Elstrom, *supra* note 67.

253. The Act uses the term "interLATA." See 47 U.S.C. § 271(a) (2002); *supra* note 6.

254. 47 U.S.C. § 271(b)(2) provides that an RBOC "may provide interLATA services originating outside its in-region States [after the date of enactment of the Telecommunications Act of 1996], subject to subsection (j)." 47 U.S.C. § 291(b)(2). Section 271(j) in turn treats certain 800 and private line services as "in-region." 47 U.S.C. § 271(j). The statute also allows RBOCs to provide "incidental interLATA services" such as audio and video programming. 47 U.S.C. § 271(b)(3).

255. For an in-depth discussion of § 271 requirements, see Sloan, *supra* note 7, at 321-86.

256. 47 U.S.C. § 271(c)(1)(A).

257. The approval process is carried out by state utility commissions under § 252. This aspect of the Act will be discussed in detail *infra* Part IV.

that the company generally offers to provide such access and interconnection”<sup>258</sup> that has been approved.<sup>259</sup>

Second, an RBOC must meet a fourteen-point checklist, which is primarily designed to ensure that the RBOC has complied with §§ 251 and 252, discussed in Part II.A.2.<sup>260</sup>

The third condition the Act specifies<sup>261</sup> is that the RBOC can only provide long distance services under the separate affiliate provisions of § 272.<sup>262</sup> Fourth, the FCC must determine that “the requested authorization is consistent with the public interest, convenience, and necessity.”<sup>263</sup>

What is particularly surprising, if not hypocritical, is that the RBOCs decided to litigate even the portion of the Act designed to help them.<sup>264</sup> They challenged § 271<sup>265</sup> as an unconstitutional bill of attainder<sup>266</sup> and won in a federal district court.<sup>267</sup> The district court’s opinion, however, was overturned on appeal.<sup>268</sup> Although the statute had passed constitutional muster, the FCC would need to implement it.

258. 47 U.S.C. § 271(c)(1)(B).

259. *See supra* note 257.

260. More specifically, the RBOC must show that it will provide:

interconnection conditions that meet § 251(c)(2) and § 252(d)(1); unbundling conditions that meet § 251(c)(3) and § 252(d)(1); nondiscriminatory access to poles and other conduits under the Pole Attachments Act, 47 U.S.C. § 224 (2003); local loop transmission; local transport; local switching; nondiscriminatory access to 911, directory, and operator services; white pages directory listing for new entrants; nondiscriminatory access to telephone numbers; nondiscriminatory access to databases and other call routing signaling; arrangements for number portability; access to information required for dialing parity; reciprocal compensation arrangements; and resale that meets § 251(c)(4) and § 252(d)(3).

*See* 47 U.S.C. § 271(c)(2)(B).

261. *See* 47 U.S.C. § 271(d)(3)(B).

262. *See* 47 U.S.C. § 272 (2002). The RBOCs are now even pushing to be free from § 272 separate affiliate requirements at a national level. *See Bells Seek Companywide Sunsets on Sec. 272 Requirements*, LONG-DISTANCE COMPETITION REP., Aug. 19, 2002.

263. 47 U.S.C. § 271(d)(3)(C).

264. *See, e.g.,* Chen, *The Magnificent Seven*, *supra* note 7, at 1577 (“The [RBOCs] lobbied vociferously for the legislation that eventually became the 1996 Act. They then had the perfidy to challenge section 271 and the other BOC provisions of the Act as bills of attainder.”). Note that the RBOCs have even tried to enter into creative arrangements to circumvent § 271; for example, US West and Ameritech signed a deal to market Qwest’s long distance. The D.C. Circuit struck this down, finding that the RBOCs are effectively “providing” long distance services. *See* US West Communications v. FCC, 177 F.3d 1057, 1060 (D.C. Cir. 1999) (inquiring “whether a BOC’s involvement in the long distance market enables it to obtain competitive advantages, thereby reducing its incentive to cooperate in opening its local market to competition” (quoting *In re AT&T Corp. et al.*, 13 FCCR 21,438, 21,465 91 37 (1998))). RBOCs have also paid fines for marketing long-distance products even before obtaining § 271 approval. *See, e.g.,* News Release, Federal Communications Commission, Verizon Admits Violations of Long Distance Marketing Ban—Company to Make \$55.7 Million Payment to U.S. Treasury (Mar. 4, 2003), available at [http://hrawnfoos.fcc.gov/edocs\\_public/attachmatch/DOC\\_231701A1.pdf](http://hrawnfoos.fcc.gov/edocs_public/attachmatch/DOC_231701A1.pdf). On the broader question of RBOC fines, *see supra* note 240.

265. In fact, the RBOCs challenged §§ 271-275, all under Part III of the Act labeled “Special Provisions Concerning Bell Operating Companies.” Sections 273-275 restrict manufacturing,

### C. Subsequent Implementation

For the first few years after the passage of the Act, no RBOC satisfied the requirements of § 271. Only five applications were approved<sup>269</sup> during William Kennard's tenure as Chairman of the FCC from 1997 to January 2001. This dearth of approvals led numerous commentators to lament the "intense regulatory scrutiny"<sup>270</sup> and advocate a less active role for the FCC. Professor Thomas Krattenmaker even complained that "[an RBOC] is not AT&T . . . . If the [RBOCs] are to be let in, they should be let in like everyone else."<sup>271</sup>

Soon after Michael Powell was designated as FCC Chairman on January 22, 2001,<sup>272</sup> however, the situation changed somewhat dramatically.<sup>273</sup> From

electronic publishing, and alarm monitoring activities. *See* 47 U.S.C. §§ 273-275 (2002).

266. "No Bill of Attainder or ex post facto law shall be passed." U.S. CONST. art. I, § 9, cl. 3.

267. *SBC Communications, Inc. v. FCC*, 981 F. Supp. 996 (N.D. Tex. 1997). For an overview of bill of attainder jurisprudence and a conclusion that the district court erred, see Thomas A. Buckley, Note, *SBC Communications, Inc. v. FCC: Does Section 271 of the Telecommunications Act of 1996 Constitute a Bill of Attainder Against the Bell Operating Companies?*, 6 COMM.LAW CONSPECTUS 225 (1998).

268. *SBC Communications, Inc. v. FCC*, 154 F.3d 226 (5th Cir. 1998). *See also* *BellSouth Corp. v. FCC*, 162 F.3d 678 (D.C. Cir. 1998) (finding that singling out of RBOCs does not raise equal protection concerns because they are not a protected class and there is a rational basis for the government's actions; also finding that the 1996 Act does not re-open the provisions of the Modified Final Judgment (MFJ) against AT&T and thereby does not violate the separation of powers doctrine). For an argument that the constitutional prohibition against bills of attainder protects political, not economic, rights, see Recent Cases, *Constitutional law—Bill of Attainder—Fifth Circuit Holds That the Special Provisions of the Telecommunications Act of 1996 Are Not a Bill of Attainder*, 112 HARV. L. REV. 1385 (1999). *But see* Karey P. Pond, Note, *Constitutional Law—The Telecommunications Act of 1996: When Legislative Regulation Becomes Unconstitutional Punishment*, 22 W. NEW ENG. L.

REV. 271 (2000) (arguing that §§ 271-276 of the 1996 Act constitute an unconstitutional bill of attainder).

269. The approved applications were Verizon in New York (Dec. 22, 1999) and Massachusetts (Apr. 16, 2001); and SBC in Texas (June 30, 2000) and Kansas/Oklahoma (Jan. 22, 2001). *See* Federal Communications Commission, RBOC Applications to Provide In-region, InterLATA Services under 271 (Feb. 28, 2003), available at [http://www.fcc.gov/Bureaus/Common\\_Carrier/in-region\\_applications](http://www.fcc.gov/Bureaus/Common_Carrier/in-region_applications) [hereinafter FCC § 271 List].

270. Crandall & Sidak, *supra* note 10, at 359. *See also* Swedenburg, *supra* note 25, at 1422.

271. Krattenmaker, *supra* note 23, at 160-61. Professor Krattenmaker goes on: "In sum, it is difficult to imagine a regulatory strategy, other than a permanent complete ban on entry into allied markets, for coping with the possibility of predatory cross-subsidization and discriminatory interconnection by Bell operating companies that is not employed, at one point or another, in the 1996 Act." *Id.* at 142.

272. *See* Federal Communications Commission, Biography of FCC Chairman Powell, available at [http://www.fcc.gov/commissioners/powell/mkp\\_biography.html](http://www.fcc.gov/commissioners/powell/mkp_biography.html).

273. The business press seems to have predicted this pattern. *See, e.g.,* Krause, *Telecom Act?*, *supra* note 26 ("With a Republican-led FCC now reviewing long-distance applications, observers expect the Bells to seek approval in many more states.").

January 2001 to January 2003,<sup>274</sup> there were thirty approvals<sup>275</sup> and no denials. RBOCs are thus free to enter long distance in most states, including heavily populated ones such as California and Florida. There are also several states where applications are under review by the FCC.<sup>276</sup>

However, this rapid increase in the pace of approvals seems to have little to do with a rapid increase in competition. For instance, in December 2000, at which time there had only been four approvals, the nationwide CLEC share of end-user lines was 8%; by June 2002, it had increased a meager 3% to 11%.<sup>277</sup> Moreover, there seem to be rather large disparities in the state of local competition even among the states that have already garnered approval. As Table 1 shows, RBOCs are now irreversibly allowed to provide long distance in states such as South Carolina and Mississippi where CLECs only have 5% or less market share.

Table 1: CLEC End-User Switched Access Line Market Share in States  
Where § 271 Approvals Already Granted<sup>278</sup>

State	CLEC Market Share (%)
Alabama	5
Arkansas	N/a <sup>279</sup>
California	9
Colorado	14
Connecticut	9
Delaware	N/a
Florida	9
Georgia	13

274. Verizon's approval to provide long distance in Massachusetts is not included here because this case was completed prior to Mr. Powell's tenure as Chairman. *See supra* note 269.

275. Verizon in Connecticut (July 20, 2001), Pennsylvania (Sept. 19, 2001), Rhode Island (Feb. 24, 2002), Vermont (Apr. 17, 2002), Maine (June 19, 2002), New Jersey (June 24, 2002), New Hampshire/Delaware (Sept. 25, 2002), Virginia (Oct. 30, 2002); SBC in Arkansas/Missouri (Nov. 16, 2001), California (Dec. 19, 2002); BellSouth in Georgia/Louisiana (May 15, 2002), Alabama/Kentucky/Mississippi/North Carolina/South Carolina (Sept. 18, 2002), Florida/Tennessee (Dec. 19, 2002); Qwest in Colorado/Idaho/Iowa/Montana/Nebraska/North Dakota/Utah/Washington/Wyoming (Dec. 23, 2002). *See* FCC § 271 List, *supra* note 269.

276. As of this writing, Verizon in the District of Columbia, Maryland, and West Virginia; SBC in Nevada and Michigan; Qwest in New Mexico, Oregon, and South Dakota. *See id.*

277. *See* FCC Local Competition Report, *supra* note 36, Table 7.

278. Based on the latest FCC statistics as of June 2002. *See id.* Table 6.

279. The FCC has withheld data "to maintain firm confidentiality." *See id.* Table 7. Note that it is quite possible that CLEC market shares in these states are low, based on the fact that if there were multiple firms competing, the ability to identify the share of one firm based on aggregate data would be quite difficult.

State	CLEC Market Share (%)
Idaho	N/a
Iowa	12
Kansas	9
Kentucky	N/a
Louisiana	5
Maine	N/a
Massachusetts	16
Mississippi	2
Missouri	8
Montana	N/a
Nebraska	16
New Hampshire	13
New Jersey	6
New York	25
North Carolina	6
North Dakota	N/a
Oklahoma	10
Pennsylvania	15
Rhode Island	18
South Carolina	5
Tennessee	7
Texas	16
Utah	13
Vermont	N/a
Virginia	12
Washington	9
Wyoming	N/a

Moreover, because the approval process apparently does not distinguish between residential and business customers, it is highly likely that even in states where there is more robust CLEC competition, the bulk of that competition is for business customers; the vast majority of residential customers are captive to the RBOC for local telephone service.<sup>280</sup>

The fundamental problem here seems to be that while the § 271 requirements sound impressive and weighty, they simply do not take into

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280. The FCC does not release state-by-state statistics on this point. However, based on national statistics, CLEC market share for residential and small business customers is less than 8%, whereas it is over 20% for medium and large businesses, institutional, and government customers. *See id.* Table 2 (percentages calculated by dividing “Reporting CLECs” lines by (“Reporting ILECs” + “Reporting CLECs” lines) for each category).

account what the actual state of competition is, nor do they distinguish between residential and business customers.<sup>281</sup> Moreover, the FCC seems to have been unable or unwilling to look beyond mechanics and approve or deny applications based on its “public interest” authority.<sup>282</sup>

It should come as little surprise that the federal courts have intuitively realized the problems in the FCC’s implementation but have by and large been unable to step in and do the FCC’s job. For example, in *AT&T Corp. v. FCC*,<sup>283</sup> long distance carriers challenged the FCC’s approval of Bell Atlantic’s<sup>284</sup> application to provide long distance in New York, arguing that Bell Atlantic had not satisfied certain elements of the fourteen-point competitive checklist.<sup>285</sup> While recognizing the potential issues raised, the D.C. Circuit ended up affirming the FCC’s decision with *Chevron*-like deference by stating that the “FCC’s decision seems reasonable.”<sup>286</sup>

Long distance companies raised a more novel legal argument in *Sprint Communications Co. v. FCC*,<sup>287</sup> where they argued that the FCC should take into account the low rate of local competition under its “public interest” standard. More specifically, the long distance companies argued that new entrants are subject to a “price squeeze” in the residential market because unbundling rates are set at such a high level that it is not possible to make a profit.<sup>288</sup> Here, the D.C. Circuit remanded to the FCC to show that it had weighed the anticompetitive effects of its pricing methodology.<sup>289</sup>

Notwithstanding the D.C. Circuit’s careful analysis, the upshot of all this is that the FCC will likely allow RBOCs to compete in long distance in virtually all states,<sup>290</sup> and the courts will defer to this implementation of § 271. Indeed, the ultimate irony here is that the combination of RBOC mergers<sup>291</sup> and long distance approvals means that the telephone market

281. See also *supra* Part III.B.

282. See *supra* note 263.

283. 220 F.3d 607 (D.C. Cir. 2000).

284. Following a series of mergers, Bell Atlantic became Nynex, and Nynex became Verizon. See also *supra* note 57.

285. 220 F.3d at 615.

286. *Id.* at 617. Note the similarity to the Supreme Court’s decision in *Verizon Communications v. FCC*, 533 U.S. 467 (2002) (No. 00-511, 2001 Term), at *infra* notes 183-86 and accompanying text.

287. 274 F.3d 549 (D.C. Cir. 2001).

288. See *id.* at 553. Note that this is merely an artifact of the flawed TELRIC methodology, which could be avoided using techniques such as ECPR. See *supra* Part II.C.5.

289. 274 F.3d at 562. The D.C. Circuit did exactly the same thing in *WorldCom, Inc. v. FCC*, 308 F.3d 1 (D.C. Cir. 2002) (remanding to the Commission, noting that “classic price squeeze cases have never turned on a finding that competition by the input-purchasing firms was *absolutely* precluded”).

290. See *supra* note 276 and accompanying text.

291. See *supra* note 57.



could largely be back to the situation it was in pre-AT&T divestiture<sup>292</sup>—now with four “baby” AT&Ts.<sup>293</sup> Contrary to Professor Krattenmaker’s comment,<sup>294</sup> then, RBOCs are actually becoming more and more like an AT&T.

Both the national press and leading academics have recently begun pointing to this disturbing state of affairs. The *New York Times* has written that “the supposed tidal wave of competition that the law was expected to unleash is barely a ripple for most local phone consumers”<sup>295</sup> and that under § 271 “[n]o actual competition . . . was required—and relatively little has materialized.”<sup>296</sup> The *Wall Street Journal* has drawn insightful parallels to the airline and banking industries postderegulation to argue that poor telecommunications deregulation may have the same dangerous effect of creating a handful of large players who have little incentive to innovate.<sup>297</sup>

Professor Lawrence Sullivan has pointed out: “There are real risks that RBOCs will gain [interexchange or long distance] access while their local monopolies remain substantially intact . . . . The risk is the one that the now displaced AT&T antitrust consent decree dealt with.”<sup>298</sup> Professors Joskow and Noll sum up the situation eloquently by stating that “*repeal of the Bell doctrine* could be the ultimate effect of the Act if [an RBOC] satisfies the checklist but local service competition never emerges.”<sup>299</sup> Professor Jim Chen even warns that there is a current threat to “reshape the mass media markets in the image of the original communications monopoly, the Bell system.”<sup>300</sup>

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292. Except perhaps for a few large business customers in denser areas.

293. Perhaps even fewer if the current RBOCs merge further.

294. See *supra* note 271.

295. Schiesel, *For Most Local Phone Users*, *supra* note 74.

296. Schiesel, *Sitting Pretty*, *supra* note 83.

297. Shawn Young et al., *Familiar Ring: How Effort to Open Local Phone Markets Helped Baby Bells*, WALL ST. J., Feb. 11, 2002, at A1. See also Schlesinger, *supra* note 77.

298. Lawrence A. Sullivan, *Elusive Goals under the Telecommunications Act: Preserving Long Distance Competition upon Baby Bell Entry and Attaining Local Exchange Competition: We'll Not Preserve the One unless We Attain the Other*, 25 SW. U. L. REV. 487, 490 (1996). Note of course that the Modified Final Judgment (MFJ), which broke AT&T up into the seven RBOCs, prohibited the RBOCs from providing long distance services.

299. Joskow & Noll, *supra* note 19, at 1281 (emphasis added).

300. Jim Chen, *The Last Picture Show (On the Twilight of Federal Mass Communications Regulation)*, 80 MINN. L. REV. 1415, 1508 (1996). It is particularly interesting to observe that at one point Professor Chen advocated RBOC entry into long distance; he has subsequently changed his mind. See Chen, *supra* note 7, at 1579-80.

#### *D. Proposed Approach*

We are thus left with a situation where a seemingly strict set of requirements, under the weight of simplistic implementation, has the potential of eviscerating the Bell doctrine. However, this situation could be avoided simply by paying attention to whether there is actual competition, and if so, where the competition is focused.

In other words, before granting an RBOC approval to enter the long distance market, there would have to be local competition in the state beyond a certain threshold, perhaps 25% to 30%. In addition, this competition could not be focused exclusively among large business customers; there would have to be a certain minimal threshold among residential customers, perhaps 15% to 20%.<sup>301</sup>

Such a proposal is not as radically different as it may appear at first. After all, commentators have already lamented the fact that § 271 approvals are premised on a mere statement of terms, rather than actual competition<sup>302</sup> and have pointed out the need for “the Commission’s review of [RBOC] interLATA applications to be forward-looking in nature—where the agency’s attention is focused less on what has happened before an application’s filing and more on what will happen in the event a request is granted.”<sup>303</sup> Even a former FCC Commissioner has argued that “the best test whether a Bell company has met the act’s [sic] requirement to open the local market is this: *do consumers have a real choice of local service providers?*”<sup>304</sup>

There are a number of ways the approval process could move away from § 271’s current formalism and toward an inquiry focused on the existence of actual competition. The most straightforward, and also least practical, would be for Congress to speak on the issue. However, given the political give-and-take,<sup>305</sup> it is already quite remarkable that Congress was able to come up with

301. The natural question that might come up regards what happens if such competition does not develop; that is, what will occur if competitors do not step up to the plate? First of all, if taken in conjunction with the unbundling and pricing reforms suggested in Part II *infra*, this is unlikely to happen. If we assume, *arguendo*, however, that such an unfortunate situation does in fact evolve, then under this methodology, the RBOC would be prohibited from entering long distance. This should be unsurprising. After all, the RBOC is still maintaining its local monopoly; it would be difficult for it to argue that it should not only hold onto its local monopoly, but also be allowed to enter long distance.

302. See, e.g., Bhagwat, *supra* note 176, at 1499-50.

303. Sloan, *supra* note 7, at 397.

304. Ness, *supra* note 17 (emphasis added). Commissioner Ness further points out that “[e]specially now, six years after the [A]ct was passed, one would expect that if the local market were truly open we would see high levels of actual competition in the residential market by service providers using a variety of forms of market entry.” *Id.*

305. See *supra* Part III.A.

the statute as it stands, as imperfect as it might be.

The more tenable solution is for the FCC to step up to the plate and actually put teeth behind its “public interest” mandate<sup>306</sup> and not allow the meeting of formal requirements to masquerade as competition. This is exactly what the FCC did recently, for example, in denying the EchoStar/DirecTV merger.<sup>307</sup> The “public interest” standard in § 271 currently appears to be inconsequential because applications are currently being approved if they meet the formal conditions set forth in the statute.<sup>308</sup> To give it meaning, the FCC must move beyond its mechanical checklist.<sup>309</sup>

In disaggregating the local network, the FCC promulgated regulations that were designed to help new competitors, but the regulations were so inefficient that they ended up hurting both incumbents and new entrants.<sup>310</sup> In allowing RBOC entry into long distance, the FCC has unleashed a process whereby RBOCs are able to provide long distance services without even having to show that their local markets are actually competitive. Doubly poor implementation has heaped insult upon injury to the cause of local competition.

#### IV. FEDERALISM

##### *A. Underlying Tension*

We come at last to the thorny issue of federalism. The previous parts of this Article present suggestions for improving the lot of local competition: apply antitrust principles to the unbundling reforms, reform the pricing algorithm to comport with economic reality, and grant long distance approvals only if viable competition actually exists.

The federalism issue is subtler and, of course, pervades our entire jurisprudence.<sup>311</sup> On the one hand, the American legal system has historically been built on state autonomy—the law respects, if not cherishes, the notion of state independence—each state as a laboratory of experimentation. On the other hand, the exigencies of modern life and globalization often require a

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306. See *supra* note 263.

307. See FCC EchoStar/DirecTV press release, *supra* note 89 (denying merger because it did not serve the “public interest, convenience, and necessity”).

308. See *supra* Part III.B.

309. See also Michael F. Finn, *The Public Interest and Bell Entry into Long-Distance under Section 271 of the Communications Act*, 5 COMM.LAW CONSPECTUS 203 (1997) (arguing for greater use of the public interest standard).

310. See *supra* Part II.C.4.

311. For an excellent discussion of the inherent tensions in federalism, see DAVID L. SHAPIRO, *FEDERALISM: A DIALOGUE* (1995).

central authority such as the federal government to impose uniformity and reign in maverick states. Many landmark Supreme Court cases have had a federalism dimension to them—from *Erie Railroad Co. v. Tompkins*<sup>312</sup> to *Bush v. Gore*.<sup>313</sup> The intersection of telecommunications and federalism is also a fertile area.

Federalism in the telecommunications context naturally has costs and benefits. Costs include the inefficiencies and possible contradictions of having parallel systems, as well as the threat of large corporations improperly influencing local regulators.<sup>314</sup> Benefits include the ability to benchmark among different agencies and the fact that splitting authority among different levels of government provides a counterbalancing force against regulatory capture by incumbents.<sup>315</sup>

The relative merit of these costs and benefits can be debated endlessly.<sup>316</sup> The reality is that the United States was founded on notions of federalism that continue powerfully to this day; it would be altogether naive and impractical to abandon these concepts and exclude the states in telecommunications policy, even assuming this would not offend traditional notions of sovereign immunity.<sup>317</sup>

Specifically in the context of local telephone competition, we must not forget that the “United States is the only country where the regulatory supervision on interconnection is shared by a federal agency (FCC) and State public utility commissions (PUCs).”<sup>318</sup> In the words of FCC Chairman Powell: “[W]e cannot succeed alone. We share authority with the states.”<sup>319</sup>

Indeed, every case under the Act that has made it to the Supreme Court has brought with it a federalism dimension, the most prominent to date being *AT&T Corp. v. Iowa Utilities Board*<sup>320</sup> and *Verizon Maryland, Inc. v. Public*

312. 304 U.S. 64 (1938).

313. 531 U.S. 98 (2000).

314. See, e.g., *supra* note 97; James K. Glassman, Editorial, *Local Phone Service Fiasco Sure Rings a Bell*, ST. LOUIS POST-DISPATCH, Dec. 15, 2000, at D17 (“These behemoths [the RBOCs] control the last mile of telecommunications into the home. Their monopoly status is protected and regulated by often captive and generous state officials.”).

315. See, e.g., LAFFONT & TIROLE, *supra* note 6, at 274-75. For an argument advocating federalism in environmental regulation using the tools of public choice analysis, see Richard L. Revesz, *Federalism and Environmental Regulation: A Public Choice Analysis*, 115 HARV. L. REV. 553 (2001).

316. As Professors Laffont and Tirole point out, with some understatement: “As for the broader issue of the optimal number of regulators, though, things are more complicated.” LAFFONT & TIROLE, *supra* note 6, at 275.

317. See *infra* Part IV.C.2.

318. 2001 OECD Report, *supra* note 41, at 12.

319. Powell Communicopia Remarks, *supra* note 9.

320. See *supra* Part IV.C.1.

*Service Commission of Maryland*,<sup>321</sup> discussed below.<sup>322</sup>

It would be belaboring the obvious to note that such litigation has necessarily created delay and uncertainty in local competition. Such debate, however, is inevitable within the broader legal tension. If channeled correctly, it may even be healthy. Congress has fashioned an innovative framework to mediate the roles among the FCC, the state commissions, and the federal courts. To be sure, there are improvements that are proposed to the framework, but it offers a valuable starting point.

### *B. Statutory Guidance*

There are three critical areas within the Act where federalism issues are prominent. First, and most famously, § 252 lays out a process by which the state commission facilitates ILEC agreements with new entrants, as required by the local competition provisions of § 251.<sup>323</sup> To begin with, a new entrant can negotiate with the ILEC;<sup>324</sup> if an agreement is reached, it is submitted to the state commission for approval.<sup>325</sup> If—as has happened in practice—the parties are unable to reach an agreement, then the state commission is required to arbitrate and resolve the dispute<sup>326</sup> within the pricing boundaries of § 252(d)(1).<sup>327</sup>

Importantly, Congress has provided two federal safeguards against state power. On the one hand, if a state commission does not carry out its responsibilities, the FCC is empowered to “issue an order preempting the State commission’s jurisdiction of that proceeding or matter [and] assume the responsibility of the State commission under this section with respect to the proceeding or matter and act for the State commission.”<sup>328</sup> On the other hand, the statute expressly provides that a party aggrieved by a state commission’s determination “may bring action in an appropriate Federal district court.”<sup>329</sup>

Second, before making any determination under § 271, the FCC is instructed to “consult with the State commission of any State that is the

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321. See *supra* Part IV.C.2.

322. In addition, *Verizon Communications, Inc. v. FCC* involved a challenge to the FCC’s authority to design and implement TELRIC. See *supra* note 183. Another Case, *Gulf Power*, dealt with federal authority to set fees for use of utility poles under the Pole Attachments Act. See *Nat’l Cable & Telecomms. Ass’n v. Gulf Power Co.*, 534 U.S. 327 (2002) (No. 00-832, 2001 Term).

323. See *supra* Part II.A.2.

324. 47 U.S.C. § 252(a)(1) (2002).

325. 47 U.S.C. § 252(e)(1).

326. 47 U.S.C. §§ 252(b)(1), (b)(4).

327. See *supra* note 106. See also First Report and Order, *supra* note 109, at 812 (noting that states retain flexibility to consider local factors when applying the TELRIC methodology).

328. 47 U.S.C. § 252(e)(5).

329. 47 U.S.C. § 252(e)(6).

subject of the application in order to verify the compliance of the Bell operating company.”<sup>330</sup>

Third, an often de-emphasized part of the Act is § 253, which is designed to remove barriers to competitive entry. The statute provides that “[n]o State or local statute or regulation, or other State or local legal requirement, may prohibit or have the effect of prohibiting the ability of any entity to provide any interstate *or intrastate* telecommunications service.”<sup>331</sup> In addition, if the FCC finds that a state or local government is violating this prohibition, it “shall preempt the enforcement of such statute, regulation, or legal requirement to the extent necessary to correct such violation or inconsistency.”<sup>332</sup> Finally, Congress has vested the United States Court of Appeals for the District of Columbia with jurisdiction to hear cases by “any applicant for authority to provide interLATA services under section 271 of [the Act] whose application is denied by the Commission.”<sup>333</sup>

The overarching message is thus relatively clear: state commissions do function as the first line of defense in ensuring CLEC competition and RBOC long distance entry. But the FCC has not only the power but the express obligation to oversee this regulatory scheme in a manner that fosters local competition. As Professor Howard Shelanski has pointed out, Congress’ preemption of state and local laws that inhibit competition should not be overlooked.<sup>334</sup>

### C. Supreme Court Interpretation

#### 1. Iowa Utilities Board

Before addressing the “necessary” and “impair” standards,<sup>335</sup> the Supreme Court in *AT&T Corp. v. Iowa Utilities Board*<sup>336</sup> had to decide the threshold issue of whether the FCC even had authority to regulate local competition, given that states have traditionally been allowed to regulate intrastate matters. The Court granted certiorari to the United States Court of Appeals for the Eighth Circuit. The Eighth Circuit, relying on Section 2(b) of the Communications Act of 1934, which does not allow the FCC to regulate

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330. 47 U.S.C. § 271(d)(2)(B) (2002).

331. 47 U.S.C. § 253(a) (2002) (emphasis added).

332. 47 U.S.C. § 253(d).

333. 47 U.S.C. § 402(b)(9) (2002). Note that allowing this jurisdiction only in cases where an application is denied may have been an additional “carrot” offered to the ILECs. *See supra* Part III.A.

334. *See* Shelanski, *supra* note 100, at 1638.

335. *See supra* note 104.

336. 525 U.S. 366 (1999).

intrastate communications,<sup>337</sup> ruled that there is a fence that is “hog tight, horse high, and bull strong, preventing the FCC from intruding on the states’ intrastate turf.”<sup>338</sup>

Writing for the majority, Justice Scalia relied on Section 201(b), a 1938 amendment to the Communications Act of 1934, that provides: “[t]he Commission may prescribe such rules and regulations as may be necessary in the public interest to carry out the provisions of [the 1934 Act].”<sup>339</sup> Justice Scalia combined this with § 251(i) of the Telecommunications Act of 1996—stipulating that “[n]othing in this section shall be construed to limit or otherwise affect the Commission’s authority under section 201”<sup>340</sup>—to find that the FCC has authority to implement the local competition provisions.<sup>341</sup>

The majority also responded to Justice Breyer’s concern that there is a presumption against preemption of state police powers because “local rates are local matters for local regulators.”<sup>342</sup> Justice Scalia noted that “[i]f there is any ‘presumption’ applicable to this question, it should arise from the fact that a federal program administered by 50 independent state agencies is surpassing strange.”<sup>343</sup>

Justice Scalia concluded by noting that the FCC has broad discretion under the Act:

The 1996 Act can be read to grant (borrowing a phrase from incumbent GTE) “most promiscuous rights” to the FCC vis-à-vis the state commissions and to competing carriers vis-à-vis the incumbents—and the Commission has chosen in some instances to

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337. “[N]othing in this chapter shall be construed to apply or to give the Commission jurisdiction with respect to . . . charges, classifications, practices, services, facilities, or regulations for or in connection with *intrastate* communication service.” 47 U.S.C. § 152(b) (2002) (emphasis added).

338. *Iowa Utils. Bd. v. FCC*, 120 F.3d 796, 800 (8th Cir. 1997). For an insightful critique of the Eighth Circuit’s view of jurisdictional matters, see Chen, *TELRIC in Turmoil*, *supra* note 179. For support of the view that the FCC should not interfere with intrastate communications, see Guzzi, *supra* note 162, at 188-90. For a nuanced argument that § 2(b) should be interpreted “to apply with greatest force to intrastate services that have a direct relationship with the consumer or end user, since this is the aspect of intrastate services that is closest to the sphere of influence of state regulators,” see Duane McLaughlin, Note, *FCC Jurisdiction over Local Telephone under the 1996 Act: Fenced Off?*, 97 COLUM. L. REV. 2210, 2250 (1997).

339. 47 U.S.C. § 201(b) (2002).

340. 47 U.S.C. § 251(i) (2002).

341. 525 U.S. at 377-78.

342. *Id.* at 420 (Breyer, J., dissenting).

343. *Id.* at 378 n.6.

read it that way. But Congress is well aware that the ambiguities it chooses to produce in a statute will be resolved by the implementing agency.<sup>344</sup>

Moving beyond the specifics of the case at hand, the Court insightfully grasped that the Act, by its very design, had moved federalism into uncharted waters. Justice Scalia noted that we now live in

a scheme in which Congress has broadly extended its law into the field of intrastate telecommunications, but in a few specified areas (ratemaking, interconnection agreements, etc.) has left the policy implications of that extension to be determined by state commissions, which—within the broad range of lawful policymaking left open to administrative agencies—are beyond federal control. *Such a scheme is decidedly novel, and the attendant legal questions, such as whether federal courts must defer to state agency interpretations of federal law, are novel as well.*<sup>345</sup>

Some commentators have criticized the Court for its reliance on supposedly textual analysis,<sup>346</sup> but others praise the court for allowing a national telecommunications policy.<sup>347</sup> The reality, as with most federalism issues, is more subtle. On the one hand, the Court correctly interpreted Congress' desire to allow the FCC broad authority to implement local competition; on the other, it acknowledged the role state commissions play, perhaps realizing, for example, that the FCC does not have the resources to do everything itself.

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344. *Id.* at 397 (citation omitted).

345. *Id.* at 385 n.10 (emphasis added). The Supreme Court later evoked the same theme in the context of pricing network elements. *See Verizon Communications, Inc. v. FCC*, 535 U.S. 467 (2002) (No. 00-511, 2001 Term), slip op. at 16 ("The approach was deliberate, through a hybrid jurisdictional scheme with the FCC setting a basic, default methodology for use in setting rates when carriers fail to agree, but leaving it to state utility commissions to set the actual rates.").

346. *See, e.g.,* John E. Taylor, Note, *AT&T Corp. v. Iowa Utilities Board: The Supreme Court Recognizes Broad FCC Jurisdiction over Local Telephone Competition*, 78 N.C. L. REV. 1645, 1704 (2000) ("Although the Court claimed to articulate the plain meaning of the 1996 Act, its decision on the pricing jurisdiction issue is better supported by the 'silent dogs' argument than by textual analysis.").

347. *See, e.g.,* Charles H. Sanders, Note, *A Step Toward Competition in Local Telephone Service: AT&T Corp. v. Iowa Utilities Board*, 12 HARV. J.L. & TECH. 647, 650 (1999) ("By firmly establishing the FCC's jurisdiction to implement the Act, the Court has effectively ensured that deregulation of local telephone service can evolve under a uniform national program, rather than dooming the process to individualized determinations in state regulatory commissions prone to capture by [ILECs].").



## 2. Verizon Maryland

In *Verizon Maryland, Inc. v. Public Service Commission of Maryland*,<sup>348</sup> Verizon filed suit against the Maryland Public Service Commission for ordering it to pay compensation to WorldCom for certain calls made by Verizon's customers.<sup>349</sup> The issue was fundamentally whether a federal court can entertain a suit against a state commission without violating the state sovereign immunity doctrine.<sup>350</sup>

Again writing for the majority, Justice Scalia determined that Verizon could bring the claim under federal question jurisdiction,<sup>351</sup> but did not decide whether § 252(e)(6) of the Act offers an alternative basis for jurisdiction.<sup>352</sup> The Court also allowed the suit against the state commissioners to proceed under the doctrine of *Ex parte Young*,<sup>353</sup> which permits a federal court to enjoin a state official from violating federal law.<sup>354</sup>

*Iowa Utilities Board* gave the federal government flexibility to preempt state actions. In many ways, *Verizon Maryland*'s narrow interpretation of state sovereign immunity complements *Iowa Utilities Board* by allowing federal judicial oversight of state utility commission actions. A slew of recent cases from the courts of appeals seems to confirm this.<sup>355</sup>

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348. 535 U.S. 635 (2002) (No. 00-1531, 2001 Term).

349. *Id.*, slip op. at 3-4.

350. The Eleventh Amendment provides that "[t]he Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State." U.S. CONST. amend. XI. The Supreme Court has interpreted the Eleventh Amendment to prevent states from being sued in federal court. Some jurists, notably Justice Souter, argue that by its own language the amendment is merely a bar to state-citizen diversity. *See Alden v. Maine*, 527 U.S. 706, 760 (1999) (Souter, J., dissenting); *Seminole Tribe of Fla. v. Florida*, 517 U.S. 44, 100 (1996) (Souter, J., dissenting). For an analysis of state sovereign immunity that predates *Verizon Maryland*, see Douglas C. Melcher, *State Sovereign Immunity and Judicial Review of Interconnection Agreements under the Telecommunications Act of 1996*, 8 COMM.LAW CONSPPECTUS 61 (2000) (providing an overview of the abrogation doctrine, waiver, and *Ex parte Young*); Jake C. Blavat, Note, *Wisconsin Bell v. Public Service Commission of Wisconsin: Problems in the Telecommunications Act in the New Age of Sovereign Immunity*, 2000 WIS. L. REV. 1149 (2000) (arguing that the 1996 Act violates the Eleventh Amendment).

351. 535 U.S. 635 (2002) (No. 00-1531, 2001 Term), slip op. at 6. 28 U.S.C. § 1331 provides: "The district courts shall have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States." 28 U.S.C. § 1331 (2002).

352. In particular, the Court reasoned that "[e]ven if § 252(e)(6) . . . does not confer jurisdiction, it does not divest the district courts of their authority under § 1331." 535 U.S. 635 (2002) (No. 00-1531, 2001 Term), slip op. at 5.

353. *Ex parte Young*, 209 U.S. 123 (1908).

354. *Ex parte Young* is fundamentally based on the legal fiction that a suit against a state official is not a suit against the state.

355. *See, e.g., US West Communications, Inc. v. Jennings*, No. 99-16247, 2002 U.S. App. LEXIS 19798, at \*16 (9th Cir. Sept. 23, 2002) ("In sum, we follow the Act's charge to the federal courts to

#### D. Proposed Approach

##### 1. Three-Tiered Methodology

In order to balance states' rights against the needs of a uniform, national telecommunications policy, a three-tiered approach should be fashioned consistent with Congress' guidance, *Iowa Utilities Board*, and *Verizon Maryland*. The first level is comprised of the state commissions: under better FCC guidance,<sup>356</sup> they are the "first line of defense" to implement the unbundling provisions of § 251<sup>357</sup> and long distance provisions of § 271.<sup>358</sup> One important modification would be to have an independent board of arbitrators, rather than the state regulatory commission, arbitrate disputes.<sup>359</sup> This alone could prevent problems from escalating into battles pitching state regulators against federal regulators.<sup>360</sup>

If, however, the issues are not resolved, then we move to the second tier where the FCC must directly step in under its statutory authority confirmed under *Iowa Utilities Board*.<sup>361</sup> If a state commission is not fulfilling its § 251 duties, the FCC must exercise its preemptive authority under § 252(e)(5).<sup>362</sup> Moreover, the FCC has more general preemption powers under § 253<sup>363</sup> if any state or local body is acting in a manner that prevents local competition.

The third and final tier consists of the federal courts. In the context of unbundling, § 252 gives specific authority for an aggrieved party to bring an action in federal district court.<sup>364</sup> Note that under *Verizon Maryland*, suing state commissions would not offend sovereign immunity and would be permissible under the doctrine of *Ex parte Young*.<sup>365</sup> In the context of § 271

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review the agreements for compliance with the Act, rather than for the correctness of the state commission's decisions."); *MCI Telecomms. Corp. v. BellSouth Telecomms., Inc.*, 298 F.3d 1269 (11th Cir. 2002) (upholding district court's reversal of Florida Public Service Commission's arbitration decision based on inconsistency with federal law); *Global NAPS, Inc. v. FCC*, 291 F.3d 832 (D.C. Cir. 2002) (holding that FCC has prerogative not to preempt a state commission's decision under § 252(e)(5)); *RT Communications, Inc. v. FCC*, 201 F.3d 1264 (10th Cir 2000) (finding that federal regulation preempts Wyoming statute designed to protect rural telecommunications carriers from competition for a period of ten years).

356. Which the FCC, unfortunately, is still having trouble giving. *See supra* note 139.

357. *See supra* notes 323-26.

358. *See supra* note 330.

359. *See* Hausman, Competition and Regulation, *supra* note 199. There is no reason that independent boards of arbitrators could not be established on a state-by-state level.

360. *See supra* notes 320-22 and accompanying text.

361. *See supra* note 341 and accompanying text.

362. *See supra* note 328.

363. *See supra* note 332.

364. *See supra* note 329.

365. *See supra* Part IV.C.2.

denials by the FCC, the United States Court of Appeals for the District of Columbia Circuit has exclusive jurisdiction.<sup>366</sup>

## 2. *Should State Agencies Be Creating Federal Common Law?*

The major question, as Justice Scalia points out, is whether the federal courts should defer to state agency interpretations of federal law.<sup>367</sup> Supporting this point of view is Professor Philip Weiser, one of the leading commentators on federalism and telecommunications. Professor Weiser argues that the Act moved away from a traditional model of federalism and toward “cooperative federalism” where state agencies implement federal authority.<sup>368</sup>

Even though this interpretation is tenable, Professor Weiser, and other like-minded commentators, have taken the argument too far to suggest that Congress could have chosen “to delegate federal authority to state agencies without FCC oversight.”<sup>369</sup> In a series of articles on the subject, he further suggests that federal courts should offer the same deference to state commission decisions as they do to federal agency decisions.<sup>370</sup> This belies two fundamental realities: Congress is not directly responsible for state agencies,<sup>371</sup> and the Act itself gives recourse to federal courts to review state agency decisions.<sup>372</sup>

In addition, Weiser suggests that somehow “the incentive for parties to

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366. See *supra* note 333.

367. See *supra* note 345.

368. See Philip J. Weiser, Chevron, *Cooperative Federalism, and Telecommunications Reform*, 52 VAND. L. REV. 1, 33 (1999) (“The underlying vision of cooperative federalism is that state agencies will compete with each other by implementing statutes like the Telecom Act in a manner that each believes will best facilitate economic development in its respective state. In so doing, they will continue to serve as ‘laboratories of democracy.’”) (quoting *New State Ice Co. v. Liebmann*, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting)).

369. Phil Weiser, *Paradigm Changes in Telecommunications Regulation*, 71 U. COLO. L. REV. 819, 823 (2000). See also Beynon, *supra* note 121, at 41-43 (arguing that FCC did not need to establish national pricing rules to implement local competition provisions).

370. See, e.g., Weiser, Chevron, *supra* note 368; Weiser, *Federal Common Law*, *supra* notes 125; Weiser, *Paradigm Changes*, *supra* note 369.

371. Professor Weiser does offer some countervailing arguments. See Weiser, Chevron, *supra* note 368, at 26-27. But his arguments that Congress can withhold money from state commissions or preempt state law are unconvincing because these arguments could be applied to virtually any state action. In addition, even though it is true that the Federal Reserve Board and Federal Sentencing Commission enjoy *Chevron* deference, such agencies are within the purview of the federal government and are hardly nonaccountable, as Professor Weiser suggests. The insularity of the Federal Reserve Board, for example, is purposely crafted within federal law to ensure independence. See also Joshua D. Sarnoff, *Cooperative Federalism, the Delegation of Federal Power, and the Constitution*, 39 ARIZ. L. REV. 205 (1997).

372. See *supra* note 329.

seek a better deal from the courts than they obtained from state regulators will be enormous.”<sup>373</sup> It is difficult to fathom, however, what incentives a federal court—rather than a state commission—has to grant either party a “better deal.”<sup>374</sup> Leaving aside these policy issues, the Act’s regulatory framework makes such suggestions unworkable. As the Supreme Court noted in *Iowa Utilities Board*: “This is, at bottom, a debate *not about whether the States will be allowed to do their own thing*, but about whether it will be the FCC or the federal courts that draw the lines to which they must hew.”<sup>375</sup>

In sum, Congress has devised a new solution to address complex notions of federalism, and the Supreme Court has determined that this scheme passes constitutional muster. Given the novelty of the approach, mistakes will happen,<sup>376</sup> and improvements will need to be made.<sup>377</sup> The system will necessarily be more complex than if Congress were simply to preempt the entire area of local telecommunications or if the federal courts were merely to defer to state agencies. Unfortunately, neither approach is practical or desirable. More importantly, neither is permitted under the careful balance the Act strikes.

373. Weiser, *Chevron*, *supra* note 368, at 47.

374. In a later article, Professor Weiser has perhaps moderated his position, suggesting that “uniformity sometimes can be one important consideration” or speaking of a “federally acceptable range of reasonableness.” Weiser, *Federal Common Law*, *supra* note 125, at 1709-11. He further adds: “Regimes should impose national rules where doing so gives rise to substantial efficiencies, protects important equity concerns, guards against substantial interstate spillovers, or prevents a ‘race to the bottom’ between states.” *Id.* Nonetheless, Weiser still posits that “[e]mbracing the state agency’s creation of federal common-law rules may prove to be the ultimate test of whether state agencies and federal courts can conceptualize properly the cooperative federalism architecture of the Telecom Act.” *Id.* at 1761.

375. *AT&T Corp. v. Iowa Utils. Bd.*, 525 U.S. 366, 378 n.6 (1999) (emphasis added).

376. See, e.g., Weiser, *Federal Common Law*, *supra* note 125, at 1746-47 (“Perhaps because the architecture of cooperative federalism regulatory regimes remains a relatively unfamiliar topic, the relevant agencies and the courts all appear to keep looking to one another to clarify how they should work in practice. Reflecting an almost comic result of this dynamic, the FCC initially justified the authority of state agencies to enforce interconnection agreements (subject to federal judicial review) on the ground that judicial questions already had endorsed this reading of the Act—ignoring the fact that the judicial decisions in question had themselves relied on the FCC’s prior suggestions of such a reading.”). See also Kimberly L. Sharkey, Comment, *Confusion in the Wake of the Telecommunications Act of 1996: What Standard of Review Should Courts Employ When Evaluating Interconnection Agreements?*, 28 FLA. ST. U. L. REV. 831, 833-34 (2001) (arguing that federal courts should apply a de novo standard to state commission interpretations of federal law unless the FCC has promulgated rules on the subject).

377. For example, section 410(b) of the Communications Act of 1934 permits boards or conferences to foster greater dialogue between state and federal regulators. One commentator suggests broader use of federal-state joint boards, in particular with regard to advanced telecommunications capabilities. See Bob Rowe, *Strategies to Promote Advanced Telecommunications Capabilities*, 52 FED. COMM. L.J. 381, 402 (2000).

## CONCLUSION

Local wireline infrastructure is not going away anytime soon and competition on these wires is unlikely to flourish without proper regulation. Current regulation has left a lot to be desired: essentially unlimited unbundling, pricing that defies economic logic, and an opportunity for RBOCs to enter the long distance market without showing actual competition in local markets. This combination, if unchanged, is a lethal impediment to competition. It is thus important to get it right.

Courts have been able to sense intuitively the importance of issues brought to them, offered advice to regulatory bodies, and have even occasionally invalidated rules. But, by and large, courts will defer to agencies under *Chevron*. As the D.C. Circuit has pointed out, courts will defer to agencies where issues involve “a high level of technical expertise in an area of rapidly changing technological and competitive circumstances.”<sup>378</sup> It is striking, for instance, that the Supreme Court’s lengthy opinion in *Verizon Communications, Inc. v. FCC* defers to the FCC on TELRIC because it is “reasonable”<sup>379</sup> and nothing more.<sup>380</sup>

Courts thus cannot be the bulwark that ensures local competition because they lack the institutional expertise—notwithstanding certain judges like Justice Stephen Breyer who hold unusual expertise in the administrative law.<sup>381</sup>

378. *Sprint Communications Co. v. FCC*, 274 F.3d 549, 556 (D.C. Cir. 2001). *See also* *AT&T Corp. v. FCC*, 220 F.3d 607, 620 (D.C. Cir. 2000) (“[W]e cannot imagine a question more suited for administrative rather than judicial resolution than whether copper or fiber loops are more cost-effective.”); *GTE Serv. Corp. v. FCC*, 205 F.3d 416, 421 (D.C. Cir. 2000) (“[T]hese terms [in § 251] are found in a *circumscribed* statutory provision that seeks to ensure competition in areas of advanced technology in telecommunications . . . . This is hardly the stuff of ‘plain meaning.’”).

379. *See supra* note 185.

380. This argument is pervasive in recent appellate opinions. *See, e.g.*, *Ass’n of Communications Enters. v. FCC*, 253 F.3d 29, 33 (D.C. Cir. 2001) (finding that the FCC is “reasonable” in saying that ILEC’s offering of DSL to ISP is not subject to resale requirements); *WorldCom, Inc. v. FCC*, 246 F.3d 690, 694 (D.C. Cir. 2001) (finding that FCC’s order saying ILECs providing DSL have § 251(c) duties is “reasonable”); *GTE Serv. Corp. v. FCC*, 205 F.3d at 421 (finding that the FCC collocation order withstands judicial scrutiny because it is not “arbitrary or capricious”); *Southwestern Bell Tel. Co. vs. FCC*, 168 F.3d 1344, 1354 (D.C. Cir. 1999) (finding that the FCC’s use of industry-wide averages to set access rates for local exchange carriers’ collocation to enable competition in long distance was not “arbitrary or capricious”). *Cf. Verizon Tel. Cos. v. FCC*, 292 F.3d 903, 911 (D.C. Cir. 2002) (accepting FCC’s revised rules on collocation of interconnection equipment); *WorldCom, Inc. v. FCC*, 238 F.3d 449, 458 (D.C. Cir. 2001) (“[I]t is not our role to second guess the FCC’s policy judgment, so long as it comports with established standards of administrative practice.”); *Southwestern Bell Tel. Co. vs. FCC*, 180 F.3d 307, 309 (D.C. Cir. 1999) (“[O]rder denying reconsideration is not reviewable for material error but only for new evidence or changed circumstance”).

381. *See supra* note 193.

The burden to reform regulation rests, as it should, with the expert agency: the FCC. The importance of the FCC's actions cannot be underestimated.<sup>382</sup> In fairness to the agency, it has been presented with a gargantuan task of enormous complexity. To begin with, the entire concept of opening local markets to competition is new.<sup>383</sup> In addition, Congress went about this task in a subtle manner: unbundle RBOC bottleneck inputs, allow RBOCs into long distance in exchange for local competition, and manage the whole process using new federalism notions that allow state commissions to implement the policy with the guidance of the FCC and oversight of the federal courts. Add to the mix an industry that is, in the words of the Supreme Court, "technical, complex and dynamic,"<sup>384</sup> and the possibility of meltdown is high.<sup>385</sup>

As Professor Krattenmaker has pointed out, "[o]ne reads the new Act in vain for something that reflects Congressional awareness that the FCC may not be omnipotent, its commissioners not omniscient."<sup>386</sup> But central to this Article's thesis is that there is really no need for the FCC to be omniscient and design the "perfect" regulatory scheme.

In fact, quite the opposite may be true. If the FCC were to get the "basics" right—what to unbundle and at what price—by looking to antitrust and microeconomic principles, that alone would go a long way to bringing about true local competition. Adding the simple notion that one would expect actual competition, not formalisms, to materialize before allowing RBOCs entrance into long distance, the improvements would be even bigger.

382. See, e.g., Sullivan, *supra* note 298, at 490 ("What this legislation means and what effects it will have will depend, as a practical matter, on the content of FCC regulations and on how that statute and regulations are administered at both the federal and state levels.").

383. See, e.g., Robinson, *supra* note 146, at 1217-18 ("Opening local markets to competition had not occurred to anyone in 1974 when the government filed the antitrust action, nor in 1982 when the courts dismembered the Bell system. The Justice Department and nearly everyone else regarded local telephone markets as a naturally monopolistic industry in which competition was not sustainable, and hence not economically efficient. Times change, and sometimes ideas change with them. In one of the most remarkable paradigm shifts in modern industrial history, Congress simply ignored the natural monopoly model.").

384. Nat'l Cable & Telecomms. Ass'n v. Gulf Power Co., 534 U.S. 327 (2002) (No. 00-832, 2001 Term), slip op. at 10. See also U.S. Telecom Ass'n v. FCC, 290 F.3d 415, 421 (D.C. Cir. 2002) ("We note at the outset the extraordinary complexity of the Commission's task.").

385. As Thomas Hazlett points out: "The telecom marketplace is a big, complicated place, and the [1996 Act] was a big, messy bill." Hazlett, *supra* note 251, at 1362. Professor Hazlett later adds, somewhat tongue in cheek: "The FCC will foul up, which is why God created Congressional oversight." *Id.* at 1367.

386. Krattenmaker, *supra* note 23, at 173. See also Robinson, *supra* note 146, at 1218 ("It must have seemed so simple to a Congress accustomed to issuing orders in the manner of Jean Luc Picard of the USS Enterprise: 'make it so, number one.' And the FCC, a dutiful if not always fully informed number one, tried to make it so.").

What Crandall and Sidak term “the current gulf between first principles and established law”<sup>387</sup> is in many ways astounding. There is no reason why the FCC should not be up to the task if it pays attention to the fundamentals discussed in this Article. Indeed, despite the latest unbundling fiasco,<sup>388</sup> an optimist might find a few encouraging signs from the FCC. For example, perhaps implicitly referring to the local competition debacle, Commissioner Abernathy advocates “adhering closely to the precise language in the statute—and refraining from broadening (or constricting) rights based on our own policy preferences.”<sup>389</sup>

Chairman Powell also has made very insightful and refreshing comments: plainly laying out the industry’s problems,<sup>390</sup> admitting that poor policy may have had something to do with the current crisis,<sup>391</sup> and underscoring the importance of regulation in a marketplace that tends toward monopoly.<sup>392</sup> He has also acknowledged the importance of the states<sup>393</sup> and has begun to use the “public interest” standard to deny license transfers.<sup>394</sup>

Occasionally, though, one is surprised by certain pronouncements. For example, in the unbundling context, the Chairman seemed to deflect responsibility from the FCC by commenting that the agency is “still in the Supreme Court trying to define the fundamentals of the policy.”<sup>395</sup> Rather, he should ask himself, first, if anything could have been done to avoid having the controversy end up in the Supreme Court and, second, whether the Supreme Court can and should be in the business of setting telecommunications policy. In an interview with the *Washington Post*, the Chairman also mentioned that he is not the “grand master chef of competition” nor a “bankruptcy court” nor “in a position to play Alan Greenspan.”<sup>396</sup> The question then becomes: at a very fundamental level, what is his vision for the agency he leads?

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387. Crandall & Sidak, *supra* note 10, at 409.

388. See *supra* note 142 and accompanying text.

389. Kathleen Q. Abernathy, *My View from the Doorstep of FCC Change*, 54 FED. COMM. L.J. 199, 209 (2002). The newest FCC Commissioner, Jonathan Adelstein, also seems to espouse this point of view. See *Health of the Telecommunications Sector: Hearing Before the Subcommittee on Telecommunications and the Internet, House Committee on Energy and Commerce* (Feb. 26, 2003) (statement of Jonathan S. Adelstein, Commissioner, Federal Communications Commission), available at [http://hraunfoss.fcc.gov/edocs\\_public/attachmatch/DOC\\_231535A4.pdf](http://hraunfoss.fcc.gov/edocs_public/attachmatch/DOC_231535A4.pdf) (“First and foremost, my role is to implement the law as written by Congress, not to impose my own policy preferences.”).

390. See *supra* note 9.

391. See *supra* note 16.

392. See *supra* note 85.

393. See *supra* note 319.

394. See *supra* note 89.

395. *Litigation Expected*, *supra* note 85.

396. Goodman, *supra* note 82.

The stakes for the FCC to get it right are enormous.<sup>397</sup> Local telephony is an industry with more than \$100 billion in yearly revenues.<sup>398</sup> Its fate necessarily impacts the entire telecommunications industry with over \$1 trillion in revenues, or about 10% of gross domestic product.<sup>399</sup> Moreover, recovery in telecommunications is critical to overall economic recovery.

Methodologically, understanding how to manage “last mile” telecommunications bottlenecks will prepare the FCC for future challenges. Today, the bottleneck is a local copper wire loop; tomorrow, it could be a fiber optic line<sup>400</sup> or another technology that is prohibitively expensive to replicate.<sup>401</sup> Interestingly, during the Internet boom years, even very distinguished commentators got swept up in the frenzy. They argued that somehow the open architecture of the Internet would make such seemingly mundane issues obsolete.<sup>402</sup> But these important questions endure.<sup>403</sup>

The themes discussed in this Article also have repercussions for regulated industries beyond telecommunications such as energy and transportation. Around the world, the mandate of regulatory agencies is being transformed

397. See, e.g., Peter J. Howe, *Get Off the Line Baby Bells Complain Telecom Rivals Get Below-Cost Access to Their Networks . . . But Critics Say Monopoly-Minded Bells Want to Crush Competition*, BOSTON GLOBE, Oct. 14, 2002, at D1 (“Much of the debate gets conducted in an incomprehensible lingo . . . [b]ut the stakes for the economy, the stock market, and consumers are vast.”).

398. See *supra* note 34.

399. See Pulley, *supra* note 8, at 78.

400. See, e.g., Hall & Lehr, Promoting Broadband Investment, *supra* note 98, at 17 (“Telecom policy needs to deal with the distinct possibility that the broadband service of the future will arrive at the home over a fiber circuit with a substantial bandwidth advantage over any wireless alternative. In that case, all of the problems connected with the Bells’ control of the existing copper circuit will remain.”).

401. Indeed, one might argue that certain components of wireless or satellite systems present “bottleneck inputs” given the extremely high capital expenditures required to create those infrastructures.

402. See, e.g., Rui J.P. de Figueiredo, Jr. & Pablo T. Spiller, *Strategy, Structure and Regulation: Telecommunications in the New Economy*, 2000 L. REV. MICH. ST. U. DET. C.L. 253, 275 (2000) (deemphasizing the importance of physical assets and arguing that “[s]uccessful telecommunications firms must thus follow their Internet counterparts to try to turn rents that have been eroded into long-term rent-generating positions. One of the key lessons that should be learned is that expansion is crucial.”); John D. Podesta, *Unplanned Obsolescence: The Telecommunications Act of 1996 Meets the Internet*, 45 DEPAUL L. REV. 1093, 1094 (1996) (“I want to discuss why the Internet may provide a paradigm which leapfrogs the current debate.”).

403. Needless to say, even framing the debate in terms of “structural separation” of ILECs into retail and wholesale businesses cannot avoid the fundamental questions: who gets what elements and at what price? For an argument against structural separation, see Crandall & Sidak, *supra* note 10; for the point of view that structural separation is a good thing, see Hall & Lehr, Rescuing Competition, *supra* note 35. For a twist on the structural separation debate, see T. Randolph Beard et al., *Why ADCo? Why Now? An Economic Exploration into the Future of Industry Structure for the “Last Mile” in Local Telecommunications Markets*, 54 FED. COMM. L.J. 421 (2002) (advocating entrance of a new exclusively wholesale carrier known as an “alternative distribution company”).



from setting retail rates to developing and implementing regulatory paradigms for accessing and pricing bottleneck inputs.<sup>404</sup> The problems that plague these industries are not intractable; however, as in telecommunications, they will surely require more than the “stroke of a pen.”<sup>405</sup>

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404. *See supra* note 93.

405. *See supra* note 2.